Dubai Financial
Services Authority

CONSULTATION PAPER NO. 83

03 MAY 2012

PROPOSED CHANGES TO THE PIB MODULE OF THE RULEBOOK

CONSULTATION PAPER NO 83

PROPOSED CHANGES TO THE PIB MODULE

Why are we issuing this paper?

1. The DFSA proposes to make significant changes to the requirements applicable in respect of:

   (a) capital adequacy for firms subject to the PIB module;

   (b) the prudential categorisation of Authorised Firms, except Insurers and Representative Offices;

   (c) group supervision requirements;

   (d) the internal risk assessment and supervisory review processes;

   (e) the disclosure standards for Authorised Firms in some categories; and

   (f) the systems and controls in respect of various aspects of prudential and financial risks assumed by Authorised Firms.

   Almost all of these requirements are currently contained in the Prudential - Investment, Insurance Intermediation and Banking (PIB) module of the DFSA Rulebook. For convenience, these provisions are collectively referred to as the "PIB module".

2. The changes proposed in this paper are designed primarily to bring the DFSA's PIB module into closer alignment with the Basel III framework and capital adequacy requirements employed by leading jurisdictions across the world, while retaining features necessary to accommodate regional needs and circumstances.

Who should read this paper?

3. The proposals in this paper would be of interest to:

   (a) Authorised Firms, except Insurers and Representative Offices;

   (b) a Parent of any Authorised Firm or any entities which might form part of a Group which includes an Authorised Firm;

   (c) credit rating agencies;

   (d) Registered Auditors and auditing firms providing various accounting and audit services to Authorised Firms; and

   (e) Financial Services Regulators, particularly in the GCC region.

4. Authorised Firms operating as Branches in the DIFC will continue to be treated in a manner similar to the current treatment in respect of prudential requirements. Branches will be given waivers from capital requirements while they will continue to be subject to all applicable systems and control requirements including the PII requirement.

How to provide comments?

5. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. 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.

Comments to be addressed or emailed to:

Consultation Paper No.83
Policy and Legal Services
DFSA
PO Box 75850
Dubai, UAE

Email: consultation@dfsa.ae

Tel: +971(0)4 3621500

What happens next?

6. The deadline for providing comments on the proposals is **01 August 2012**. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We shall then proceed to enact the proposed changes to the DFSA Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Background

7. The global financial crisis triggered a series of global regulatory initiatives, driven by the G20. These initiatives resulted in a wide range of measures, some of which covered aspects of prudential supervision of financial institutions. The global standard setters have also focused on ensuring timely and effective implementation of these measures. One of the new measures was a further revision of the Basel capital adequacy framework for banks, known as Basel III. The proposals in this paper aim to implement the Basel III capital adequacy framework for Authorised Firms carrying out banking and proprietary risk-taking businesses. We have also taken the opportunity in line with our policy of subjecting our rulebook to rolling reviews, to update other aspects of our capital adequacy regime. We believe that these proposals will ensure the adequacy and relevance of the DFSA's prudential rules, in light of current regulatory and market developments.

8. The current DFSA capital adequacy regime for banks and other firms exposed to similar risk is based dominantly on Basel I. The Basel II Accord, finalised in 2006, was not implemented in the DIFC, because by the time it appeared appropriate to do so it was already clear that the financial crisis would result in substantial changes to that Accord. The first set of changes was agreed in 2009; this is sometimes known as Basel 2.5. Basel III was approved at the end of 2010. Certain aspects of it, however, are subject to monitoring periods before new rules are implemented. The substance of the regime proposed in this paper is thus substantially similar to that of Basel 2.5, save that we have implemented the Capital Conservation Buffer and capital quality enhancements of Basel III, and have naturally taken note of the levels at which different jurisdictions have set capital requirements.

9. Although relatively few jurisdictions have as yet implemented Basel III, we have consulted the implementation proposals of the EU (CRD IV) and other jurisdictions, notably Singapore. We have also drawn on existing implementations of Basel II. In certain areas, for example Market Risk, the Basel III regime involves little change from the final version of Basel I and much of the text can therefore be carried over from the existing Rulebook.

Replacement of the PIB module

10. Because the proposals involve significant augmentation and refinements to a very high proportion of the current provisions in the PIB module, and restructuring of the various chapters in the module to a significant extent, we intend to revoke and replace this module in its entirety. The PIB module will be replaced with the new version of the Prudential Rules for Investment, Insurance Intermediation and Banking (PIB) module (see Appendix 1).

11. We also propose less extensive changes to other modules of the DFSA Rulebook, as a consequence of the changes proposed to the PIB module, such as the Islamic Finance Rules (IFR) module (see Appendix 2) and some consequent amendments to the Glossary (GLO) module whereby PIB specific definitions are now set out under PIB Rule 1.2.1 (see Appendix 1).

Structure of the paper

12. The proposals in this paper are structured, for convenience, substantially to mirror the chapter headings used in the proposed new version of the PIB module as follows:

(a) Terminology – paragraph 13;

(b) Part 1: Prudential categorisation – Paragraphs 14 and 15;

(c) Part 2: Capital requirements – Paragraphs 16 - 34;

(d) Part 3: Capital Resources - Paragraphs 35 – 40;

(e) Part 4: Rules relating to Credit Risk – Paragraphs 41 – 70;

(f) Part 5: Rules relating to Market Risk – Paragraph 71 - 74;

(g) Part 6: Rules relating to Operational Risk – Paragraphs 75 - 80;

(h) Part 7: Rules relating to Interest Rate Risk in the Non-Trading Book – Paragraphs 81 - 83;

(i) Part 8: Rules relating to Group Risk – Paragraphs 84 - 86;

(j) Part 9: Rules relating to Liquidity Risk – Paragraph 87;

(k) Part 10: Rules relating to supervisory review process – Paragraphs 88 - 102;

(l) Part 11: Rules relating to disclosure requirements – Paragraph 103 - 106;

(m) Part 12: Discretionary Powers – Paragraph 107; and

(n) Part 13: Transitional Rules – Paragraph 108.

Terminology in this paper

13. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments in this paper, in particular, the Table under PIB Rule 1.2.1. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Part 1: Prudential Categorisation

Splitting Prudential Category 3

14. This section provides a brief description of the proposed changes to the prudential categorisation of Authorised Firms. Following an intensive review of the current prudential category structure and applicability of risk capital requirements, it was identified that the current prudential category 3 included some firms which expose their capital to risk as a matter of business and some that do not. For example, firms dealing in investments as agent are likely to be exposed to counterparty risks. In contrast, firms managing assets or providing custody are not likely to expose their capital as part of their normal business activities.

15. In order to facilitate implementation of more risk-sensitive capital requirements and to streamline the application of other rules in the PIB module, it is proposed that firms in the current prudential category 3 be split into three different categories, namely 3A, 3B and 3C. The remaining prudential categories in the

current structure are being retained, save for movement of the activity of managing restricted PSIAs from category 5 into the proposed category 3B. This move is proposed to group the activities with similar risk profiles into the same categories so that application of rules to address the risks can be aligned in an efficient manner. The table below provides a picture of the proposed prudential category structure.

Prudential Category	Financial Services
Category 1	Accepting Deposits, Managing Unrestricted PSIA's (other than as a wholly Islamic Firm)
Category 2	Providing Credit, Dealing in Investments as Principal
Category 3A	Dealing in Investments as Matched Principal, Dealing in Investments as Agent.
Category 3B	Providing Custody for a Fund and Acting as the Trustee of a Fund
Category 3C	Managing Assets, Managing a Collective Investment Fund, Managing Restricted PSIAs, Providing Trust Services (where it is acting as trustee in respect of an express trust) and Providing Custody (other than for a Fund).
Category 4	Arranging Credit or Deals in Investments, Advising on Financial Products or Credit, Arranging Custody, Insurance Intermediation, Insurance Management, Operating an Alternative Trading System, Providing Fund Administration, Providing Trust Services (where it is not acting as trustee in respect of an express trust);
Category 5	Managing Unrestricted PSIAs (as a wholly Islamic Firm)

Part 2: Capital requirements

16. The revised classification described above facilitates a tailored application of capital adequacy rules as well as other prudential rules specifying risk management requirements. The proposed rules are generally consistent with the current regime in respect of the overall framework for determination of capital requirements. The changes incorporated in the proposed rules relate to the application of different capital requirement components and the methodologies involved in computation of those capital requirements components, as described below.

17. The overall framework for determination of capital requirements will continue to involve the three components used in the current regime – Base Capital Requirement (BCR), Expenditure Based Capital Minimum (EBCM) and Risk Capital Requirement (RCR). Essentially, the capital requirement for any Authorised Firm will continue to be determined as the highest of the applicable components out of the three described above, depending on its prudential category. The application of the three components to Authorised Firms in different categories is detailed below. For some firms a Capital Conservation Buffer (CCB) will also be applicable as described below.

18. In summary, the following table illustrates the application of different components of capital requirements to firms in various prudential categories.

Categories	BCR	EBCM	RCR	CCB
3C, 3B and 4	✓	✓	×	×
2 and 3A	✓	✓	✓	✓
1 and 5	✓	×	✓	✓

Base Capital Requirements

19. The proposed rules envisage no changes to base capital requirements from the current dispensation, except for the financial service of Managing Restricted PSIAs. Managing Restricted PSIAs is proposed to be classified as part of category 3B with a base capital requirement of USD 500,000 as compared to the current level of USD 10 million. This follows given the proposal to treat Managing Restricted PSIAs analogously to Managing Assets, the rationale for which is detailed below in paragraph 31.

20. The BCR applicable to various financial services is detailed in the table below.

Category	Proposed BCR
Category 1	US $10 million
Category 2	US $2 million
Category 3A	US $500,000
Category 3B	US $4 million
Category 3C	US $500,000
Category 4	US $ 10,000
Category 5	US $10 million

Expenditure Based Capital Minimum (EBCM)

21. The proposed rules do not involve changes to the basic methodology for calculation of EBCM or to the proportion of annual audited expenditure used to determine applicable EBCM in current rules. However, we propose some changes to the calculation of Annual Audited Expenditure, which are aimed at better aligning the calculation with the underlying objective of maintaining EBCM. In brief, the changes to the calculation of Annual Audited Expenditure involve the following:

    (a) Removal of interest expenses on various obligations from the deductions allowed; and

    (b) Inclusion of pre-paid expenses or advances which have already been paid and have been deducted from Capital Resources as illiquid assets.

Risk Capital Requirement (RCR)

22. The proposed rules involve a totally new approach and changes in the methodologies used for determination of most of the components of RCR. The determination of the amount of RCR has also been simplified by removing the multiplication factor of 125% used in the current regime, while keeping the level of RCR at essentially the same level. Under the proposed regime, RCR will be determined at 10% of the Risk-Weighted Assets (RWAs) of an Authorised Firm, compared to the current regime which involves RCR at 8% of RWAs, scaled up by a factor of 125%. It is obvious that the effect of the proposed rules is the same as that of the current rules, but it avoids the unnecessary complication of using a scaling factor.

23. The proposed changes to determination of RCR also involve inclusion of a new capital requirement component to address operational risk exposures and a new approach to determination of credit risk capital requirement. These changes are primarily driven by the Basel III standard and are discussed in further detail in subsequent sections of this paper.

24. In respect of firms conducting Islamic Financial Business, we now propose that the Capital Requirement relating to displaced commercial risk should apply only to Unrestricted Profit Sharing Investment Accounts (PSIAs). It will no longer apply to Restricted PSIAs, which we propose should be treated analogously to asset management.

Capital Conservation Buffer (CCB)

25. In addition to the capital requirement based on RWAs as described above, the proposed regime also includes a Capital Conservation Buffer (CCB), which is set at 25% of the RCR of an Authorised Firm to which it applies. The CCB will apply to all Authorised Firms which are subject to RCR and is proposed to act as an additional buffer to protect firms from breaching capital requirements in the event of large, unexpected losses. The decision to set the overall capital requirement (RCR + CCB) at 12.5% of RWAs is based on the need to comply with the Basel III standard, maintain consistency with global trends towards higher capital requirements, and to ensure parity with regional jurisdictions while avoiding undue regulatory burden.

26. The detailed rules being proposed for implementation of CCB involve the imposition of specific requirements on maintenance of CCB, quality of capital required to be maintained to meet CCB requirement and consequence of not being able to meet CCB. The detailed rules are specified in section 3.9 of the proposed PIB module. The proposed rules on CCB include:

    (a) CCB being set at 25% of RCR and in addition to RCR;

    (b) that CCB must be met with Common Equity Tier 1 Capital (CET1 Capital) only – refer to Part 3 for details on composition of Capital;

    (c) that any breach of CCB will trigger a series of gradual restrictions on any profit or capital distributions that can be made by the Authorised Firm;

    (d) the methodology for calculation of the maximum amount of distributions an Authorised Firm can make, which depends on the extent to which its CCB has been depleted;

    (e) the distributions which are covered by these rules; and

(f) a requirement to prepare and submit a Capital Conservation Plan to the DFSA, for its review and approval.

The proposed rules on CCB are in line with those prescribed by the Basel III standard. The effect of these rules on CCB are that an Authorised Firm to which it applies will not be able to make any distribution exceeding the maximum distributable amount as defined in these rules. The maximum distributable amount will gradually decline if the depletion of the CCB increases and the firm will not be able to distribute any amount if its CCB nears depletion.

27. The CCB is a key component of the Basel III standard and is being implemented at the same level as it is prescribed in Basel III. The CCB will also enhance the safety and resilience of complex firms in the DIFC in terms of their ability to absorb large unexpected losses and continue to operate.

Counter-Cyclical Capital Buffer (CCCB)

28. The Basel III framework includes a proposal to implement a Counter-Cyclical Capital Buffer (CCCB) as a macro-prudential tool to address emerging system-wide risks. We do not propose to implement CCCB at this time, as the metrics and methodologies involved are not seen as appropriate to the risk profile of Authorised Firms and have not yet been implemented in any other jurisdiction. The DFSA will keep under review the progress made by the Basel Committee on Banking Supervision (BCBS) and by other jurisdictions.

29. Having described the changes to the determination of capital requirements and changes to the required levels of the three components of capital requirements, we proceed to describe the application of these capital requirement rules to Authorised Firms in various categories.

Capital requirements for Authorised Firms in categories 3B, 3C and 4

30. The most important change which pertains to Authorised Firms in proposed categories 3B and 3C is the proposal to remove application of RCR. There will be no change in the methodology for determination of Capital Requirement for firms in category 4. The proposal to remove RCR for Authorised Firms in categories 3B and 3C is based on their risk profile, as they are not likely to assume any on-balance sheet risks like credit or market risks, as part of their normal business activities. The Capital Requirement for Authorised Firms in categories 3B, 3C and 4 will be determined as the higher of their EBCM and applicable BCR.

31. The proposed rules involve a major change for Authorised Firms in category 3C which are involved in managing Restricted PSIAs. Such firms are expected to have a risk profile very similar to that of asset management firms and consequently deserve to be treated in the same way as asset management firms. The operational aspects as well as the various resources and systems and controls requirements for firms managing Restricted PSIAs are similar to that of other firms in category 3C, like asset managers. Hence, it is considered appropriate to apply a similar prudential treatment to these firms. Consequently, these firms are proposed to be classified under category 3C and be subject to applicable BCR and EBCM, while being excluded from RCR. We shall be bringing forward proposals for Restricted PSIAs to be treated as Client Assets and subject to the same protection.

32. The proposed rules also require Authorised Firms in Categories 3B, 3C and 4 to maintain their EBCM in the form of liquid assets. Liquid assets, for this purpose

are defined in the rules detailed in section 3.5 of PIB. This is to ensure that Authorised Firms in compliance with the EBCM requirement and have adequate liquid capital to meet the expenses intended to be covered with EBCM.

Capital requirements for Authorised Firms in categories 2 and 3A

33. The application of capital adequacy rules as well as other rules regarding risk management obligations to firms in categories 2 and 3A is proposed to be identical to current PIB rules. Essentially, their Capital Requirement will continue to be determined as the highest of Risk Capital Requirement (RCR), Expenditure Based Capital Minimum (EBCM) and Base Capital Requirement. The proposed rules do not involve any changes from the current dispensation in respect of BCR and EBCM for these firms, except for the changes in the calculation of EBCM described above. The rationale for the continued application of risk capital requirements to Authorised Firms in these categories is based on their risk profile which is expected to involve material levels of on-balance sheet financial risks. These firms will be subject to the CCB requirement as they are subject to RCR. The need to ensure financial safety and resilience and mitigate potential risk contagion are the reasons for the proposed application of rules.

Capital requirements for Authorised Firms in categories 1 and 5

34. The proposed approach to determining Capital Requirements as well as risk management obligations for firms in categories 1 and 5 involves no change from the current PIB rules. Essentially, their Capital Requirement will continue to be determined as the higher of RCR and applicable BCR. There are no changes being proposed in respect of applicable BCR for these firms. The CCB requirement will be applicable to these firms as they are subject to RCR. Authorised Firms in these categories, being firms involved in activities like deposit taking or equivalent financial services, are required to be covered by the Basel III standard which includes the proposed RCR and CCB requirements. The need to ensure financial safety and resilience and mitigate potential risk contagion are the reasons for the proposed application of rules.

Issues for consideration

1. Do you have any concerns relating to any of the proposals, in particular:

   a. treatment of Managing Restricted PSIAs as identical to that of Managing Assets and consequent removal of RCR for firms managing Restricted PSIAs?

   b. removal of RCR for Authorised Firms in categories 3B and 3C?

   c. imposition of CCB requirement on Authorised Firms and in particular on Firms in category 3A?

   d. liquid asset requirement to extent of their EBCM on Authorised Firms in categories 4, 3B and 3C?

   e. decision not to implement a CCCB?

Part 3: Capital Resources

Structure of Capital Resources

35. The changes being proposed under this section are driven by the need to enhance the quality of capital, following the lessons learnt during the global financial crisis. The proposed rules are based on the norms prescribed under Basel III. The applicability of the proposed structure of Capital Resources on Authorised Firms in categories 3B, 3C and 4 is consistent with the current regime and does not involve any additional regulatory burden. Firms in these categories will also be subject to liquid asset maintenance requirements to the extent of their EBCM and CET1 Capital requirements to the extent of their BCR, on an on-going basis.

36. The proposed structure of Capital Resources consists of three main components: Common Equity Tier 1 Capital (CET1 Capital), Additional Tier 1 Capital (AT1 Capital) and Tier 2 Capital (T2 Capital). CET1 Capital and AT1 Capital combine to form Tier 1 Capital (T1 Capital). The overall structure of the Capital Resources calculation according to the proposed PIB module is as follows:

	Reference to Rules in proposed PIB
(A1) Elements of Common Equity Tier 1 (CET1) Capital	Rule 3.13.2 and section 3.16
(A2) Adjustments to/deductions from CET1 Capital	Rules 13.3.5 and 13.3.7
(A3) CET1 Capital = A1 – A2	Rule 3.13.1
(A4) Elements of Additional Tier 1 (AT1) Capital	Rule 3.14.3
(A5) Deductions from AT1 Capital	Rule 3.14.4
(A6) AT1 Capital = A4 – A5	Rule 3.14.1
(A7) Tier 1 (T1) Capital = A3 + A6	Rule 3.12.1
(A8) Elements of Tier 2 (T2) Capital	Rule 3.15.3
(A9) Deductions from T2 Capital	Rule 3.15.4
(A10) Tier 2 (T2) Capital = A8 – A9	Rule 3.15.1
(A11) Capital Resources = A7 + A10	Rule 3.11.1

37. The composition of the various components of Capital Resources, the eligibility criteria for qualification of capital elements to be considered for inclusion in any of these components, regulatory adjustments and allowable deductions to any of these components are consistent with the Basel III standards for quality of capital. The detailed rules on these aspects are specified in sections 3.13 to 3.15 of PIB as referred to in the table above.

38. The proposed rules on eligibility criteria and allowable deductions for various components of Capital Resources are consistent with the intent of the current PIB rules as they aim to ensure a high quality of permanent capital. The changes primarily involve more precise specification of eligibility criteria and provisions to preclude the use of capital of inferior quality in terms of permanence or loss absorbency.

39. The primary changes in the area of calculation of Capital Resources from the current PIB rules are as follows:

(a) much tighter specification of qualifying criteria for each of the capital components, in terms of their legal standing as well as terms and conditions of the instruments involved;

(b) tighter controls on distributions related to these capital elements;

(c) clearer specification of their required seniority in claims in any insolvency proceedings;

(d) more precise definitions of required deductions from each of the capital components;

(e) changes in the treatment of material holdings of investments in other regulated financial institutions;

(f) introduction of specific deductions for deferred tax assets, defined benefit pension fund assets, holdings of own capital instruments and cross-holdings designed to inflate the capital resources of the firm;

(g) a requirement for AT1 Capital instruments to be written down or converted to CET1 Capital instruments, when the CET1 Capital falls below 66.25% of the RCR for the firm; and

(h) the removal of provisions governing the use of subordinated debt in current rules, which will be covered under proposed rules governing T2 Capital.

Composition of Capital Resources

40. The proposed rules specifying the mandatory proportion of different components of Capital Resources are located in section 3.2 of PIB. The intended effect of the proposed rules on the desired composition of Capital Resources is consistent with the norms prescribed in the Basel III framework. The share of superior quality capital components proposed is higher than the share prescribed under Basel III. The implication of this proposal is that the intended capital composition is more conservative and would result in a better quality of capital resources. The rationale behind the chosen proportions for different capital components is to employ a structure which is simple and easy to implement, though it is more conservative than that prescribed under Basel III. The detailed composition of the Capital Resources being proposed is detailed in the following table along with the minimum proportions prescribed in the Basel III framework.

		Basel III	Current Proposal
		as a % of RWA	as a % of RWA
Common Equity Capital	CET1	4.50	6.00
Additional Tier 1 Capital	AT1	1.50	2.00
Tier 1 Capital (CET1 + AT1)	T1	6.00	8.00
Tier 2 Capital	T2	2.00	2.00
Total Capital (T1 + T2)	TC	8.00	10.00

Composition Limits

CET1 as % of T1		75.00%	75.00%
AT1 as % of T1		25.00%	25.00%
T1 as % of Total Capital		75.00%	80.00%
T2 as % of Total Capital		25.00%	20.00%

Issues for consideration

2. Do you have any concerns about our proposals regarding calculation of Capital Resources, specification of eligibility criteria for each of those components and required deductions for different components of Capital Resources? If so, what are those concerns and how should they be addressed?

3. Do you have any concerns about the proposed composition of Capital Resources and the proposed minimum shares of different components which are required to be maintained by Authorised Firms? If so, what are those concerns and how should they be addressed?

Part 4: Credit Risk

Overview

41. The changes proposed under this part are primarily aimed at achieving one of the key objectives of this project – to enhance the risk sensitivity of the PIB rules. The proposed rules aim to achieve increased risk sensitivity by implementing the Basel III framework's Pillar 1 provisions in respect of credit risk. Considering the nature and complexity of Authorised Firms which assume credit risks and the credit risk profile of a typical bank or principal dealer in the DIFC, we have proposed implementation of the Standardised Approach to credit risk capital charge determination. This approach is part of the menu of choices available for implementation of Pillar 1 of Basel III.

42. Pillar 1 of the Basel III framework also offers an alternative approach, the Internal Ratings Based approach (IRB approach), which relies on internal models of banks to calculate credit risk capital requirements. The IRB approach uses internal estimates of risk components in determining capital requirements for different classes of credit exposures. We do not propose to implement the IRB approach, as firms in the DIFC do not have the requisite level and depth of historical data and resources required for effective implementation of IRB approach.

43. As per Pillar 1 of Basel III, the move to the Standardised Approach will involve determination of credit risk capital requirement based on risk weights assigned on the basis of credit risk assessments from recognised external credit rating agencies. This will replace the current PIB regime's Basel I approach to measurement of credit risk. Many smaller jurisdictions have taken this approach of choosing the Standardised Approach while avoiding the advanced approaches available under Pillar 1. Jurisdictions with large markets like UK, Australia and Singapore have also adopted the Standardised Approach as an option for their smaller and less complex firms.

44. Other proposed enhancements relating to credit risk aimed at improving the risk sensitivity and risk coverage include stronger provisions to address securitisations, better rules for ensuring adequate risk transfer while addressing credit risk mitigation and enhanced counterparty credit risk management requirements. The proposals for the credit risk chapter also include a change in the application of rules, as Authorised Firms in categories 3B and 3C will no longer be covered by the rules in this chapter. This is consistent with the changes to the rules in respect of capital requirements and liquid asset

maintenance for such firms, which are not expected to be exposed to financial risks and consequently to any concentration risk exposures.

Issues for consideration

4. Do you have any concerns about our proposals to implement the Standardised Approach to credit risk under Pillar 1 of Basel III?

5. Do you have any concerns relating to the decision to not implement advanced approaches available under Pillar 1 of Basel III?

6. If so, what are those concerns and how should they be addressed?

Main Changes to Credit Risk rules

45. The primary changes being proposed to rules addressing credit risk are as follows:

(a) more detailed and enhanced requirements relating to credit risk strategy, policy, processes, procedures, systems and controls;

(b) implementation of a new methodology to calculate Credit Risk Capital Requirement (CRCOM) based on the Standardised Approach to credit risk, as defined in Pillar 1 of Basel III;

(c) providing for the use of the Simplified Approach as defined under Basel III for firms in category 3A;

(d) implementation of enhanced credit risk mitigation provisions which are consistent with the Basel III framework;

(e) more detailed and precise rules to ensure adequate risk transfer while addressing securitisation as a credit risk mitigation; and

(f) enhanced provisions in respect of concentration risk.

Improvements to Credit Risk systems and controls requirements

46. The proposed changes in this area involve more detailed and enhanced requirements relating to Credit Risk strategy, policy, processes, procedures, systems and controls to advance the aim of ensuring robust credit risk management among Authorised Firms (section 4.4 of PIB). The proposed rules also specify requirements to implement and maintain appropriate policies, processes, systems and controls to ensure adequate credit risk assessment and pricing while managing credit risk (section 4.5 of PIB). The proposed requirements relating to credit risk assessment specify clearly defined criteria for identification of problem credits and impaired assets and impose a requirement to specify minimum provisioning for impaired assets as part of a firm's credit risk policy. There are no changes to the current rules relating to lending to Related Persons. Consistent with the current rules, the proposed rules also place the responsibility for effective implementation of the required credit risk systems and controls requirements on the Governing Body of an Authorised Firm.

Issues for consideration

7. Do you have any concerns about our proposed requirements in respect of credit risk strategy, policy, processes, systems and controls? In particular, are there any concerns regarding the specific requirements being proposed in respect of classification problem credits and minimum provisioning requirements? If so, what are those concerns and how should they be addressed?

Implementation of Standardised Approach of Basel III

47. The proposed rules implement the Standardised Approach available under Pillar 1 of Basel III for calculation of CRCOM. These rules (sections 4.6 to 4.12 of PIB) are entirely consistent with the Basel III framework and the national discretions made available under the framework. In brief, the proposed rules implement this approach using the following key steps:

(a) calculation of the value of exposures (section 4.9) and recognition of any eligible credit risk mitigation (section 4.13 and 4.14);

(b) categorisation of exposures (section 4.10);

(c) assigning appropriate Credit Quality Grades based on the ratings provided by recognised credit rating agencies (sections 4.11 and 4.12);

(d) assigning appropriate Credit Risk Weights(CRWs) for each exposure, based on their Credit Quality Grade assigned in the previous step (section 4.12);

(e) calculating Credit RWAs as a product of the value of each exposure and the assigned CRW for that exposure; and

(f) calculating CRCOM as 10% of the Credit RWAs calculated above.

48. The key proposal in this entirely new segment of the proposed rules is the proposal to rely on credit ratings provided by recognised credit rating agencies for measurement of CR and consequent determination of CRCOM. The proposed rules also include provisions for determination of CRCOM for securitisation exposures, methodologies for measurement of exposure value for different kinds of CR exposures, methodologies for measurement of credit risk mitigation available under different options and rules specifying assignment of CRWs for exposures with various Credit Quality Grades in each of the various exposure classes.

49. The proposed rules require Authorised Firms to use the credit ratings issued by recognised Credit Rating Agencies (CRAs). The DFSA will separately publish the methodology and criteria it will adopt for the process of recognition of CRAs which would make their ratings eligible for use by the Authorised Firms to comply with these rules. The DFSA will also publish the list of recognised CRAs and the mapping of the rating scales of such CRAs to the Credit Quality Grades referred to in the proposed PIB Rules. The Credit Quality Grades are mapped to the rating scales of each external credit rating agency, recognised by the DFSA for the purposes of this module. Once a rating agency is recognised, the DFSA will have to map the recognised rating agency's rating scale onto the credit quality grades. The methodology and the process of mapping need not be rules but need to be disclosed. The process is specifies as part of Basel III and the

executive has already prepared a draft version which will be published once the new module goes into effect.

50. The detailed rules and methodologies described by these rules are entirely consistent with the Basel III framework. We draw attention to the proposed rules arising out of important national discretions available under the Basel III framework and exercised by the DFSA.

(a) assigning 0% CRW for any CR exposure to central governments or central banks of any GCC country which are denominated and funded in the domestic currency;

(b) determining CRW for exposures to banks based on the credit ratings of the respective bank, rather than CRWs based on the credit rating of the sovereign in which the bank is based;

(c) sovereign Public Sector Entities (PSEs) in the GCC member countries are to be treated as eligible for 0% CRW provided they are treated as such by their home regulator and the exposures are funded in the domestic currency;

(d) assigning CRWs for exposures to any PSE where such exposure is denominated in foreign currency at one rating notch less favourable than the claims on the Sovereign where the PSE is established;

(e) retaining 100% CRW for all unrated exposures;

(f) retaining the current 50% CRW for all residential mortgage exposures with LTV of up to 80% and 100% CRW where LTV exceeds 80%; and

(g) assigning 150% CRW to all high-risk exposures like investments in venture capital funds, alternative investment funds including private equity funds and securitisation tranches rated BB or below.

Issues for consideration

8. We would like to hear your concerns, if any, regarding the use of ratings from recognised credit rating agencies as part of our rules to determine CRCOM. If you have any specific recommendations to address your concerns, we would like to hear them as well.

9. Do you have any concerns about our proposed rules arising out the exercise of national discretions available under the Basel III framework?

Use of Simplified Approach

51. The proposed rules mandate the use of the Simplified Approach for firms in category 3A and allow the use of Simplified Approach as an option, subject to approval by the DFSA, for firms in category 2. The proposed rules are entirely consistent with the Simplified Approach as defined under Pillar 1 of the Basel III framework. This approach is less risk-sensitive but simpler to implement and hence is seen as appropriate for firms with limited credit risk exposure profile. This is the rationale for applying this approach to firms in category 3A.

52. The proposed rules implementing the Simplified Approach involve the use of country risk scores of export credit agencies participating in the "Arrangement on Officially Supported Export Credits" of the Organisation for Economic

Cooperation and Development (OECD), for assigning CRWs to exposures to sovereign and bank counterparties. All CR exposures to corporates are required to be mandatorily risk-weighted at 100%. The options available for recognition of credit risk mitigation are limited only to use of financial collateral and guarantees. Except for these the rules for the Standardised Approach as described above are applicable to the Simplified Approach as well. In comparison with the current prudential rules on calculation of CRCOM, the Simplified Approach involves very limited changes.

Issues for consideration

10. Do you have any concerns about the use of the Simplified Approach by firms in category 3A or the provision to allow firms in category 2 to use the Simplified Approach? In particular, are there any concerns or practical limitations in the use of the Simplified Approach as defined in the proposed rules by smaller firms? If so, what are those concerns and how should they be addressed?

Implementation of enhanced credit risk mitigation provisions

53. Credit Risk Mitigation (CRM) is used by banks to reduce their exposure to credit risks and consequently receive a regulatory capital relief. CRM techniques share a common characteristic: they all permit the transfer of credit risk from one party to another. CRM transactions involve one party willing to mitigate or reduce its credit risk and another party willing to take the risk instead.

54. The proposals in this area are aimed at achieving the objective of strengthening the soundness of the DFSA Credit Risk framework through the implementation of more risk-sensitive approaches to capital regulation and to ensure compliance with international regulatory standards. The proposed rules in this section are consistent with the general principle of the Basel III framework that no transactions in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used. This is consistent with the current PIB rules.

55. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. The proposed rules include a set of detailed legal and operational requirements for using CRM in order to reduce these residual risks. The proposed rules include provisions mandating compliance with specific requirements for each type/category of risk mitigation. These requirements are designed to ensure that firms are both aware and capable of adequately managing their exposures. Capital relief is therefore conditional upon both the transaction and the Authorised Firm complying with the proposed requirements.

56. The proposed rules allow for the use of four categories of risk mitigants with separate rules for determining the extent of credit risk mitigation for each category of credit risk mitigants. The four categories are identified as follows:

- use of financial collateral;
- on-balance sheet netting;
- financial guarantees; and

- credit derivatives.

57. The proposed rules allow the use of financial collateral as eligible for CRM but clearly define the items that are eligible for use, mostly restricted to instruments that can be quickly disposed of and converted into cash. Physical collateral is ineligible because it cannot always fulfil this condition.

58. The proposed rules detailed in section 4.13 of PIB allow Authorised Firms to opt for either the Simplified Approach or the Comprehensive Approach for the treatment of collateralised financial transactions in the non-trading book, and the Comprehensive Approach for transactions in the trading book. Both these approaches are subject to specific sets of operational requirements. In general, the Simplified Approach substitutes the risk weight of the collateral for the risk weight of the counterparty for the collateralised portion of the exposure. The Comprehensive Approach allows fuller offset of eligible financial collateral against exposures by effectively reducing the exposure amount by the value ascribed to the collateral.

59. The proposed rules provide detailed operational requirements and methodologies for calculation of the extent of credit risk mitigation that can be recognised and consequently the reduction in CRCOM for any exposure making use of an eligible CRM technique. The proposed rules for implementing the Comprehensive Approach include the methodologies for calculating the appropriate haircuts for the value of the collateral to account for volatility in the value of the collateral. These proposed methodologies are consistent with the Basel III framework.

60. Under the Comprehensive Approach, it is proposed that firms are allowed to use either the standard supervisory haircut methodology for the determination of haircuts, or own estimates for haircuts, subject to a prior approval from the DFSA. The proposed rules stipulate that the DFSA will consider approval of the use of the own-estimates approach only if an Authorised Firm has already been allowed by the DFSA to use an internal model for market risk capital requirements. The DFSA also reserves the discretion to impose additional conditions or restrictions on the use of this approach.

61. The proposed rules in respect of the Comprehensive Approach also permit the use of Value at Risk (VaR) models to determine haircuts for repo-style transactions, subject to a prior approval from the DFSA and only if an AF has already been allowed to use such model by the DFSA for market risk capital requirements and upon meeting the specified conditions. The proposed rules allow application of zero haircut for repo-style transactions which satisfy specific requirements detailed in the rules and where the counterparty is a Core Market Participant. The detailed rules in App 4 of PIB define a Core Market Participant.

62. The proposed rules addressing the use of on-balance sheet netting as a means of credit risk mitigation are similar to the current rules addressing this issue. But the proposed rules have been enhanced in line with the Basel III framework with the enhancements incorporating the treatment of currency mismatches.

63. Under the current PIB rules, debit and credit balances should be denominated in the same currency or can be in different currencies that are freely convertible. The proposed rules require the application of an 8% supervisory haircut, based on a 10-day business holding period and daily mark-to-market to arrive at the value of the collateral which can then be used in the determination of exposure value.

64. The proposed rules addressing credit risk mitigation using guarantees or credit derivatives are similar to the treatment under the current DFSA framework. These provisions have been enhanced with more specific and detailed contractual and operational requirements that have to be fulfilled to recognise guarantees and credit derivatives for credit risk mitigation. These comprise certain requirements which are common to both guarantees and credit derivatives, additional requirements specific to guarantees, and additional requirements specific to credit derivatives. The proposed rules involve the application of haircuts to address currency mismatches in use of guarantees for the purpose of credit risk mitigation.

65. A maturity mismatch occurs during the use of credit risk mitigation, when the residual maturity of a mitigant is less than that of the underlying exposure. Where there is a maturity mismatch, the proposed rules include methodologies to adjust the amount of protection provided by any credit risk mitigant, which is a significant improvement from the current PIB rules which specify such requirements only for use of credit derivatives.

Issues for consideration

11. Do you have any concerns about the proposed rules regarding credit risk mitigation arrangements and their effect on determination of CRCOM? If so, what are those concerns and how should they be addressed?

Securitisation framework

66. The proposals in the section on Securitisation (section 4.14 of PIB) are aimed at enhancing the securitisation framework of the Credit Risk chapter and bringing it in line with the Basel III standard. The proposed rules in this section are similar to the current PIB rules in terms of the underlying policy implications

67. The proposed rules do not change the scope of application of the rules. The main changes from the current dispensation will primarily be the provision of greater granularity in relation to acceptable securitisation frameworks together with greater granularity around application of credit risk capital charges applicable to securitisation exposures. Similar to the approach to CR exposures, the methodologies for calculation of CRCOM for any securitisation exposures are also proposed to be based on ratings determined by recognised credit rating agencies.

68. The main elements of the proposed rules relating to securitisation are as follows:

(a) enhanced systems and controls for the use of securitisations;

(b) detailed methodologies for calculation of the Credit RWAs and consequently CRCOM for exposures arising from securitisations including assignment of CRWs;

(c) detailed rules on treatment of most senior exposures and exposures in a second loss position of Asset Backed Commercial Paper (ABCP);

(d) treatment of eligible liquidity facilities including detailed eligibility criteria;

(e) enhanced rules on credit risk mitigation and transfers to Special Purpose Entities (SPEs); and

(f) methodologies for calculation of Credit RWAs for early amortisation exposures.

Issues for consideration

12. Do you have any concerns about the proposed rules in respect of securitisation exposures and associated credit risk mitigation provisions? If so, what are those concerns and how should they be addressed?

Concentration Risk

69. The proposed rules under this section (section 4.15 of PIB) are similar to current rules in respect of basic large exposure and concentration risk limits. The proposed rules involve material enhancements aimed at addressing the deficiencies in the current regime and issues faced by Authorised Firms in dealing with these provisions over the past. The proposed enhancements involve exclusions for short-term exposures incurred as part of normal banking activities which do not involve material concentration risk exposures and streamlining the use of parental guarantees as an effective concentration risk mitigant. Consequent to the change in application of credit risk chapter of PIB, which no longer applies to Authorised Firms in categories 3B and 3C, such firms will not be covered by any concentration risk limits.

70. The incremental additions in the proposals compared to the current PIB regime include

(a) the institutional exemption for exposures to financial institution or to a group of Connected Counterparties, a member of which is a regulated financial institution;

(b) improved definitions of exclusions from large exposure limits;

(c) enhanced provisions for the use of parental guarantees to qualify for exemption from concentration risk limits; and

(d) improvements to the definition of exempt exposures.

Issues for consideration

13. Do you have any concerns about the proposed rules in respect of concentration risk? If so, what are those concerns and how should they be addressed?

Part 5: Market Risk

71. The changes proposed under this part are primarily aimed at enhancing the risk coverage as well as improving the risk sensitivity of the rules in respect of market risk. The proposed rules addressing market risk exposures are very similar to the rules in the market risk chapter of the current PIB module. The proposed rules are consistent with the Basel III framework for market risk exposures and with the prudential standards followed by leading jurisdictions. Additional rules being proposed as part of this review primarily fall into the following two categories:

(a) rules to address gaps in risk coverage; and

(b) rules to improve risk measurement and management standards.

72. The proposals falling in the first category include rules for calculation of capital requirements for collective investment fund risk exposures. The proposals to enhance risk measurement include those aimed at improving the methodologies and addressing weaknesses in respect of option risk capital requirements and securities underwriting risk capital requirement.

73. The current PIB rules in respect of market risk allow the use of internal models for determination of the Market Risk Capital Requirement, subject to the approval of DFSA. We propose to continue with the same arrangement. However, we propose more comprehensive guidance on various aspects of the use of internal models as part of our efforts to improve the quality of risk management standards. The proposals also include enhanced guidance for validation and stress testing of internal models to measure market risk and determine capital requirements.

74. The proposed enhancements to guidance are consistent with the Basel III standard and cover the following aspects:

(a) an incremental risk charge to capture the effect of default and migration risk;

(b) internal models for correlation trading portfolios; and

(c) prudent valuation.

Issues for consideration

14. Do you have any concerns about the proposed rules and guidance in respect of market risk? In particular, do you have any concerns in respect of the introduction of a capital requirement for exposures to collective investment fund units and enhanced methodologies for determination of option risk and securities underwriting risk capital requirements? If so, what are those concerns and how should they be addressed?

Part 6: Operational Risk

75. One of the most significant initiatives toward enhancing risk coverage, a key objective of this project, is the proposal to introduce prudential rules addressing operational risk. The overall approach to implementing operational risk rules is consistent with the Basel III framework and operational risk standards published by other standard setters like the International Organisation of Securities Commissions (IOSCO). In line with our approach outlined above, application of operational risk rules is also designed with the aim of ensuring consistency with the likely operational risk profile of different types of firms. Consequently, our proposals in this regard involve applying capital requirement and systems and control requirements for firms in categories 1, 2, 3A and 5, while other firms would face only systems and controls requirements and Professional Indemnity Insurance (PII) requirements wherever appropriate.

76. As mentioned above, the operational risk capital requirements are not applicable to Authorised Firms in categories 3B, 3C and 4. Such firms face only systems and controls requirements and professional indemnity cover requirements wherever appropriate, as mitigants against operational risk. Firms dealing as

agent face an operational risk exposure profile which is similar to that of banks and hence are suitable to be addressed with capital for absorbing resultant losses. Benchmarking support for this policy approach is available from Singapore and UAE regulations for similar firms.

77. The application of various components of the proposed rules on operational risk to Authorised Firms licensed to carry out various financial services is detailed in the table below:

Financial Services	Current Prudential Category	Proposed new Prudential Category	Capital requirement	Systems and controls requirement	PII cover
Accepting Deposits	1	1	YES	YES	NO
Providing Credit	2	2	YES	YES	NO
Dealing in Investments as Principal	2	2	YES	YES	NO
Dealing in Investments as Matched Principal	3	3A	YES	YES	NO
Dealing in Investments as Agent	3	3A	YES	YES	NO
Managing Assets	3	3B	NO	YES	YES
Managing a Collective Investment Fund	3	3B	NO	YES	YES
Managing a Restricted PSIA	3 or 5	3B	NO	YES	YES
Providing Custody	3	3B or 3C	NO	YES	YES
Providing Trust Services	3	3B	NO	YES	YES
Acting as the Trustee of a Fund	3	3C	NO	YES	YES
Arranging Credit or Deals in Investments	4	4	NO	YES	YES
Advising on Financial Products or Credit	4	4	NO	YES	YES
Arranging Custody	4	4	NO	YES	NO
Insurance Intermediation	4	4	NO	YES	YES
Insurance Management	4	4	NO	YES	YES
Providing Fund Administration	4	4	NO	YES	YES
Operating an Alternative Trading System	4	4	NO	YES	NO
Managing an Unrestricted PSIA	5	5 or 1	YES	YES	NO

78. The detailed proposals for systems and controls requirements cover a range of operational risk issues including, but not limited to, IT systems risk, information security risk, risks related to outsourcing, business continuity and disaster

recovery requirements and operational risks related to trading activities. The proposals in these respects have been drafted to preclude any overlap or repetition with existing requirements in other part of the DFSA Rulebook.

79. The proposed methodologies for determination of operational risk capital requirement for Authorised Firms which are subject to such requirement are entirely based on the Basel III framework provisions on operational risk capital requirement. Basel III provides three major approaches to determine operational risk capital requirement, namely, the Basic Indicator Approach, the Standardised Approach and the Advanced Management Approach. It is proposed that Authorised Firms must use the Basic Indicator Approach as the default method to determine their capital requirement. Relevant Authorised Firms are also offered an option to use the Standardised Approach or its variant, the Alternative Standardised Approach, subject to prior approval of the DFSA.

80. The proposed rules regarding the maintenance of PII cover by firms subject to such requirements require that the PII cover be appropriate to the nature, size, complexity and risk profile of their business activities. The proposals also require the firms to provide the DFSA with a copy of the PII cover at least on an annual basis as well as notify the DFSA if there are any material changes to the PII cover, in terms of the level of coverage, its renewal or termination.

Issues for consideration

15. Do you have any concerns about the proposed rules and guidance in respect of operational risk? In particular, do you have any concerns in respect of the introduction of capital requirement and PII requirements for specific financial services as detailed above? If so, what are those concerns and how should they be addressed?

Part 7: Interest Rate Risk in the Non-Trading Book (IRRBB)

81. IRRBB, also known as structural interest rate risk, refers to the risk of economic losses for an Authorised Firm, arising from the impact of adverse movements in interest rates on its Non-Trading Book. This differs from market risk faced by Authorised Firms on interest rate sensitive positions in their Trading Book. IRRBB results from the net interest rate exposure on the balance sheet structure of an firm, which results from the specific business strategy or business model employed by the firm. Usually, IRRBB is measured in terms of its impact on the Net Interest Income and consequently on the earnings capability of the firm, rather than in terms of loss of value on its interest rate-sensitive positions. Since the risk of loss or reduction of earnings arises from the way in which the balance sheet is structured, this risk is sometimes referred to as structural interest rate risk.

82. The Basel III framework addresses IRRBB as part of its Pillar 2 component and hence does not involve any capital requirement to address this risk. This aspect of prudential rules is also stated as a core principle for banking supervision by the Basel Committee for Banking Supervision. The current PIB module does not include any rules in respect of this risk. The proposed rules in this part are consistent with the standards specified in Basel III and the methodologies implemented by leading regulators across the world. Considering the nature of the risk involved and the source of IRRBB, it is proposed that the proposals be applicable only to Authorised Firms in categories 1 and 2, both on a solo basis and on a consolidated basis.

83. The detailed proposals (Chapter 7 of PIB) in respect of IRRBB are as follows:

(a) no explicit capital requirements to address IRRBB;

(b) capital requirements to address IRRBB may be imposed on an AF, following the completion of its Pillar 2 processes and if its outcome indicates the need for capital to address IRRBB exposure;

(c) appropriate Systems and Controls requirements to address IRRBB; and

(d) specific rule requirements on measurement methods, governance around IRRBB management framework and stress testing requirements for IRRBB.

Issues for consideration

16. Do you have any concerns about the proposed rules and guidance in respect of interest rate risk in the Non-Trading Book? If so, what are those concerns and how should they be addressed?

Part 8: Group Risk

84. The overall approach to prudential rules addressing group risk and consolidated prudential supervision of Financial Groups has not changed significantly from the current PIB rules. The changes to the rules in this part involve a clearer definition of Financial Group and a more definitive expression of the DFSA's approach towards implementation of Financial Group consolidated supervision. These improvements are consistent with the standards on group supervision and approach used in major jurisdictions.

85. The proposed changes to rules in this part also include improvements to the method for calculation of the Financial Group Capital Requirement and Financial Group Capital Resources. As per the proposed rules, Financial Group Capital Requirement must be calculated only on the basis of the Financial Group's consolidated financial statements, prepared according to International Financial Reporting Standards. The proposed rules require the deduction of illiquid assets in the determination of Financial Group Capital Resources as the exemption for such deduction available in the current rules is being removed.

86. In addition to the above, the proposed rules in this part include specific restrictions on the control and ownership of Authorised Firms licensed to accept deposits and restrictions on a firm in categories 3A, 3B, 3C and 4 from owning or controlling a firm licensed to accept deposits or manage Unrestricted PSIAs, or an insurer.

Issues for consideration

17. Do you have any concerns about the proposed rules in respect of Financial Group supervision and Financial Group capital adequacy requirements? If so, what are those concerns and how should they be addressed?

Part 9: Liquidity Risk

87. The overall approach, application and the rule requirements addressing liquidity risk have not changed materially from the current PIB rules. The DFSA has decided to implement the Basel III requirements in accordance with the implementation timelines and approach recommended under the Basel III framework which begins with an observation phase which will run until January 2015. In line with the recommended approach, the DFSA has already started the implementation of the relevant liquidity ratio requirements and enhanced monitoring of liquidity risk under the observation phase. In this phase, the DFSA will collect the data regarding the recommended liquidity risk metrics on a quarterly basis and monitor them over several quarters. This monitoring effort combined with the feedback from relevant Authorised Firms on the feasibility and relevance of the liquidity metrics and ratios being monitored will provide the DFSA with adequate data to fine tune and calibrate the liquidity metrics before final implementation by 1 January 2015. This is entirely consistent with the timelines and approach suggested under the Basel III framework.

Issues for consideration

18. Do you have any concerns about the approach being followed by the DFSA in implementing the Basel III liquidity requirements? In particular, do you have any concerns or feedback on improvement opportunities in respect of the ongoing data collection and monitoring for liquidity risk among category 1 and 5 firms? If so, what are those concerns and how should they be addressed?

Part 10: Supervisory Review and Evaluation Processes

Overview of the proposals

88. This part deals with the implementation of the provisions under Pillar 2 of the Basel III framework. The overall approach and the detailed proposals in this part are very similar to the requirements which were proposed and offered to the public for comments in July 2008. The primary elements of the proposals involve:

    (a) application of the full Pillar 2 processes of Individual Capital Adequacy Assessment Process (ICAAP) and Supervisory Review Process (SRP) to Authorised Firms in categories 1, 2, 3A and 5;

    (b) for Authorised Firms in categories 3B and 3C, completion of an Internal Risk Assessment Process (IRAP) on an annual basis and submission of the results to the DFSA for review and evaluation; and

    (c) in respect of Authorised Firms in categories 1, 2, 3A and 5, introduction of a possible Individual Capital Requirement (ICR).

89. The proposed implementation and consequent Rule changes apply only to Domestic Firms which are in categories 1, 2, 3A, 3B, 3C and 5. The scope of application of the proposed Rules varies across the types of firm with less complex firms being subject to simpler requirements. For example, the proposed rules applicable to firms in categories 3B and 3C are restricted to the IRAP requirements.

90. Domestic Firms in categories 1, 2, 3A and 5 will be covered by the full scope of the Pillar 2 implementation because of the relatively higher levels of risk posed by these 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 firms maintain adequate capital to address all risks faced by them.

91. Domestic Firms in categories 3B and 3C 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. Although Basel III 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 III will ensure that the DFSA's regulatory framework continues to reflect best regulatory practices. In this context we note that within Europe the relevant Directives apply a Basel III based approach to investment firms corresponding largely to our own categories of 3A, 3B and 3C.

92. 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. The overall approach to implementation, described below, is broadly consistent with the approach taken by the European Banking Authority and is in line with guidance produced by the BCBS.

Issues for consideration

19. Is it appropriate to implement Basel III Pillars 2 and 3 in the financial services industry of the DIFC? If not, why not?

Pillar 2

93. All Domestic Firms to whom the proposals apply (i.e. firms in categories 1, 2, 3A, 3B, 3C or 5) 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 adequately to identify, measure, 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 an Authorised Firm to ensure a robust level of corporate governance over its IRAP so that the results are meaningful and contribute towards the objective of improving the internal risk management of the firm.

94. Additionally, Domestic Firms in category 1, 2, 3A or 5, 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 ICAAPs so that the objective of ensuring adequate capital to address all risks is effectively achieved. 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.

95. 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.

96. The SREP review of a firm's ICAAP may lead to the conclusion that the firm may need 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 calculated using relevant PIB 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.

97. 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 IRAPs the proposed rules attempt to give a structured framework to meet this current 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.

Issues for consideration

20. Do the key elements of the Pillar 2 proposals (IRAP, ICAAP and ICR) apply to the appropriate types of Authorised Firms? If not, what changes should be made in their application?

Detailed proposals in respect of Pillar 2

98. The proposed rules in respect of implementation of Pillar 2 provisions are located in chapter 10 and App 10 of PIB.

99. The proposed section 10.3 of PIB requires a Domestic Firm which is in category 1, 2, 3A, 3B, 3C or 5 to establish and maintain an IRAP. The IRAP must identify, assess, aggregate and monitor the risks faced by the firm. The proposed App 10 provides guidance on the types of risks that should be considered when a firm undertakes its IRAP.

100. The proposed section 10.4 of PIB stipulates the requirement for a Domestic Firm in category 1, 2, 3A or 5 to carry out an ICAAP on the basis of the results of its IRAP. Proposed App 10 provides Guidance on the ICAAP.

101. Appendix 10 of the revised PIB includes the proposed detailed guidance in respect of the SREP process. The proposed guidance in this section elaborates the proposed process the DFSA intends to follow in reviewing and evaluating 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.

102. Proposed rules in section 10.6 of PIB 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.

Issues for consideration

21. Are the proposed amendments clear and unambiguous?

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

Part 11: Disclosure Requirements

103. The objective of the proposals in this part is to implement Pillar 3 of the Basel III framework. The primary objective of this framework 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.

104. 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, measure, monitor and control those risks are important factors market participants consider in their assessment of a firm.

105. The proposed Rules (Chapter 11 of PIB) apply the disclosure requirements to Domestic Firms in categories 1, 2 and 5. In the case of Financial Groups including an Authorised Firm to which Chapter 11 of proposed PIB applies, the disclosure requirements are placed on the top-level entity of the Financial Group.

106. In the case of a Domestic Firm within category 1, 2 or 5, the proposed section 11.2 of PIB and App 11 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 consistent with the disclosures prescribed in Pillar 3 of the Basel III framework.

Issues for consideration

23. 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?

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

Part 12: Discretionary Powers

107. Effective implementation of the Basel III capital adequacy framework and compliance with the Basel Core Principles for effective banking supervision require the DFSA to have specific discretionary powers to address prudential risks in some areas of Authorised Firms' activities. For example, the DFSA would need the powers to impose or vary minimum provisioning requirements, or to alter the concentration risk limits for specific institutions when faced with identified risks. The DFSA intends to seek such discretionary powers by proposing appropriate changes to the Regulatory Law 2004. Such proposals will be published for consultation in the next few months.

Part 13: Transitional Rules

108. We do not at present see any need for transitional rules as we believe most firms will be compliant with the new requirements when they are introduced, provisionally in October of this year. Where there are firm-specific issues, firms have the option of seeking transitional waivers or modifications to the new Rules. We shall nevertheless be open to any reasoned arguments for transition provisions with indications of the specific parts of PIB to which they should apply.

Issues for consideration

25. What, if any, transitional provisions are required?

26. How long should they operate?