



ABU DHABI GLOBAL MARKET
سوق أبوظبي العالمي

CONSULTATION PAPER NO. 5 OF 2019

26 NOVEMBER 2019

**UPDATES TO THE
“PRUDENTIAL – INVESTMENT, INSURANCE
INTERMEDIATION AND BANKING”
RULEBOOK**

CONTENTS

INTRODUCTION	3
BACKGROUND	5
UPDATING THE PRUDENTIAL REGIME IN PRU	7

INTRODUCTION

WHY ARE WE ISSUING THIS PAPER?

1. The Financial Services Regulatory Authority ("**FSRA**") of Abu Dhabi Global Market ("**ADGM**") has issued this consultation paper to invite public comments on its proposals to amend the prudential regulatory regime for investment, insurance intermediation and banking institutions in ADGM, contained in the Prudential – Investment, Insurance Intermediation and Banking Rulebook ("**PRU**"). These proposals complement those proposed for PRU in Consultation Paper No. 4 of 2019¹, "Proposed Miscellaneous Amendments to FSRA Regulations and Rules".

WHO SHOULD READ THIS PAPER?

2. The proposals in this Consultation Paper will be of interest to Authorised Persons with a Financial Services Permission in ADGM, other institutions operating in the investment, insurance intermediation and banking sectors and professional advisors.

HOW TO PROVIDE COMMENTS

3. All comments must be in writing and sent to the address or email address specified below. If sending your comments by email, please use the number of the consultation paper in the subject line. You may, if relevant, identify the institution you represent in providing your comments. FSRA 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 supported by reasoning and evidence will be given more weight by FSRA.

WHAT HAPPENS NEXT?

4. The deadline for providing comments on these proposals is 5 January 2020. We will consider whether any modifications are required to these proposals in the light of the comments received. We will then proceed to publish the

¹ <https://www.adgm.com/legal-framework/public-consultations> (October 2019)

final rules and guidance relating to these proposals and any consequential amendments required in other parts of the Rulebook.

5. You should not act on these proposals until the final rules and guidance are issued by FSRA. We shall issue a notice on our website telling you when this happens.

COMMENTS TO BE ADDRESSED TO:

Consultation Paper No. 5 of 2019
Financial Services Regulatory Authority
Abu Dhabi Global Market Square
Al Maryah Island
PO Box 111999
Abu Dhabi, UAE
Email: consultation@adgm.com

BACKGROUND

1. The FSRA is proposing to update the prudential regime contained in PRU to align it more closely with the regulatory framework (the “**Basel Framework**”²) developed by the Basel Committee on Banking Supervision (“**BCBS**”). The main proposals are in relation to the Net Stable Funding Ratio (“**NSFR**”) and the Large Exposures (“**LE**”) requirements where the FSRA believes it is necessary and appropriate to update its prudential regulatory framework at this time.

The Basel Framework

2. Following the global financial crisis a decade ago, the BCBS undertook the development of “**Basel III**”³, which supplemented and reinforced the regulatory framework that was in place during the crisis, comprising “**Basel II**” (originally published in 2004) and “**Basel 2.5**” (2009)⁴; collectively, these three bodies of work form the Basel Framework.
3. Basel III was a response, covering both capital and liquidity, to shortcomings that had been identified in the framework that was in place during the crisis. The implementation of Basel III has been staggered, starting in 2013 and with its final standards due to be implemented in 2022.

ADGM - investment, insurance intermediation and banking institutions

4. In ADGM the prudential regulatory regime (the “**regime**”) adopted by the FSRA for these firms is largely based on the Basel Framework, given that it provides internationally-recognised, transparent and robust prudential standards. Although the Basel Framework is strictly applicable only to banks and similar credit institutions, it underpins the regime detailed in PRU, which also has investment firms within its scope, in a manner similar to the current Capital Requirements Directive IV (“**CRD IV**”) in the European Union (“**EU**”).

² https://www.bis.org/basel_framework/index.htm?m=3%7C14%7C697

³ <https://www.bis.org/bcbs/basel3.htm>

⁴ Both covered at <https://www.bis.org/publ/bcbsca.htm>

5. The FSRA implemented a significant revision of PRU in January 2018 to reflect additional aspects of the Basel Framework, such as the introduction of the Countercyclical Capital Buffer, requiring firms to meet the Leverage Ratio and to hold capital resources against potential credit valuation adjustment (“**CVA**”).
6. The FSRA has since continued to identify and evaluate further elements of Basel Framework that are appropriate for implementation in ADGM, but which are not currently reflected in PRU. This consultation paper presents proposals related to those aspects now deemed to be appropriate for implementation in ADGM, namely the NSFR and amendments to the LE requirements, with implementation proposed for January 2020.

Disclosure requirements

7. Furthermore, the FSRA has examined the current disclosure requirements which apply to all Authorised Persons in prudential Categories 1, 2 or 5. These largely represent an enactment of the Basel II disclosure requirements, as updated by Basel 2.5. Given the current stage of development of the market in ADGM and the participants therein, the current disclosure requirements are believed to be disproportionate and unduly burdensome for those Authorised Persons within its scope. Accordingly, a reduced set of disclosure requirements is being proposed, as outlined below.

Miscellaneous amendments

8. This consultation exercise also contains further, less substantial proposals with the objectives of:
 - clarifying the expectations that the FSRA has of Authorised Persons, e.g. how Authorised Persons should calculate their minimum capital requirements for operational risk in the three-year period after receiving their Financial Services Permission (“**FSP**”); and
 - amending inconsistencies in PRU, e.g. in definitions, cross references and rules.

9. Further background detail on the proposals in the areas of the NSFR, the LE regime, disclosure and the most significant miscellaneous amendments is given below.

UPDATING THE PRUDENTIAL REGIME IN PRU

KEY PROPOSALS

10. The key proposals, with the detailed drafting amendments contained in Appendix 1, are to:
 - (a) introduce the Net Stable Funding Ratio;
 - (b) update the Large Exposure requirements;
 - (c) make the disclosure requirements more proportionate; and
 - (d) make miscellaneous amendments to address inconsistencies and provide additional guidance.

(a) Net Stability Funding Ratio

11. Basel III introduced two, complementary liquidity standards aimed at making banks more resilient to liquidity stresses in the short-term and also requiring them to maintain a stable funding profile over a lengthier timeframe. One of these standards has been already implemented by the FSRA for Authorised Persons in Categories 1, 2 and 5, namely the Liquidity Coverage Ratio⁵ (“**LCR**”). This requirement is designed to address liquidity concerns over a timeframe of thirty days by ensuring that those Authorised Persons hold sufficiently liquid and high-quality assets that can be readily converted into cash in the event of a liquidity stress, thereby allowing them to meet their liabilities as they fall due within that timeframe.
12. The NSFR⁶ complements this measure by considering funding over a longer time horizon, i.e. of one year, and aims to promote the longer-term resilience of banks by making them fund their activities with more stable

⁵ <https://www.bis.org/publ/bcbs238.htm> (January 2013)

⁶ <https://www.bis.org/bcbs/publ/d295.htm> (October 2014)

funding. It is intended to work with and counterbalance the cliff-edge effects of the LCR by restricting the ability of banks to fund long-dated assets with short-term funding that matures just outside the thirty-day time horizon of the LCR.

13. The NSFR is calculated by dividing the available stable funding (ASF) of a bank by its required stable funding (RSF). The items falling under the ASF and RSF are weighted to reflect the degree of stability of liabilities and assets respectively, with the resulting ratio always needing to have a minimum value of 100%.

Maturity Mismatch approach

14. Authorised Persons within the scope of the NSFR and the LCR are also required to assess their short-term liquidity profile over a maturity horizon of thirty days using the Maturity Mismatch approach in PRU. Given that the LCR requires Authorised Persons to maintain an adequate level of unencumbered high-quality liquid assets over the same time horizon, we are also proposing removing this requirement under the Maturity Mismatch approach as we believe that there is a significant degree of duplication with the LCR and that it is more appropriately covered under the latter.
15. We are also proposing a simplification of the table that specifies the discount factors to be applied to marketable assets. The table would instead refer to the categories of liquid assets that are used when determining the LCR, thereby taking advantage of a common categorisation across the two measures.
16. Additionally, the “Maturity Mismatch approach” will in future be known as the “Liquidity Mismatch Approach” in order to avoid any potential for confusion with the defined term “Maturity Mismatch” that is used in relation to credit risk mitigation.

Benchmarking

17. In determining whether to implement the NSFR or not, we have undertaken a benchmarking exercise across other relevant jurisdictions in relation to

their implementation of the NSFR, including Hong Kong, Singapore and Australia. Additionally, benchmarking has also led to the proposed RSF factors to be applied to off-balance sheet exposures, those being a matter of national discretion for the relevant regulatory authority. For the FSRA this exercise has resulted in those RSF factors for off-balance sheet exposures being set at the same values as they attract for calculation of the LCR. In relation to those RSF factors, and more generally, the proposals are in line with the requirements in those other jurisdictions.

Proposal

18. The FSRA is proposing to introduce the NSFR in ADGM, in order to complement the LCR and across the same population of Authorised Persons.

ISSUES FOR CONSIDERATION

Q1: THE FSRA INVITES COMMENTS ON ITS PROPOSAL TO INTRODUCE THE NSFR.

(b) Large Exposures

19. The current LE requirements in PRU, which limit excessive exposure to a single entity or a group of connected entities, fall under sections 4.15 and A4.11, both headed “Concentration Risk”, and they are largely compliant with those introduced under Basel III⁷. Firstly, we are proposing that the term “Concentration Risk” be replaced throughout PRU with “Large Exposures” as there are other aspects of concentration risk (e.g. sectoral, geographical) that are not covered at length in PRU; this proposal would make the terminology in PRU more consistent with that used in the Basel Framework.
20. Furthermore, we are proposing that the LE requirements be updated in two areas:

⁷ <https://www.bis.org/publ/bcbs283.htm> (April 2014)

- to use Tier 1 as the denominator of the ratio used for determining whether one or a group of connected exposures are Large Exposures and the associated upper limits; and
 - reporting requirements for Large Exposures.
21. PRU currently uses total Capital Resources, i.e. Tier 1 plus all Tier 2, as the denominator of the ratio; this is wider than the definition of “eligible capital” in Basel III which is limited to Tier 1 items only, i.e. “going concern” capital. The use of Tier 1 plus Tier 2 in PRU for LE purposes also has the scope to be considerably less binding a condition than currently exists in PRU for identifying the extent of Capital Resources permitted for assessing capital adequacy, where Tier 2 is limited to one-quarter of Tier 1.
22. In relation to the reporting requirements for Large Exposures, Basel III requires a bank to report the following exposure values to its supervisor:
- all LEs, considered both before and after eligible CRM;
 - all exempted exposures that meet the definition of an LE; and
 - the largest twenty exposures, whether or not they are LEs.
23. We believe that the reporting of this information by those Authorised Persons within the scope of the LE requirements will provide supervisors with greater oversight of their exposure profile and any potentially significant exposures to single or connected entities.

Benchmarking

24. In assessing the appropriateness of revising the LE requirements at this time, the FSRA has conducted a benchmarking exercise across a number of leading international jurisdictions that are subject to the Basel Framework. We have also considered the comparable regime in the EU where CRD IV is very largely based on the Basel Framework and where the denominator in the LE ratio is also being brought into line with Basel III, i.e. it too will comprise Tier 1 only.

Proposals

25. We are therefore proposing that:

- Tier 1 be considered as appropriate for the purposes of identifying and limiting Large Exposures and, for the sake of consistency with the Basel Framework, also for determining the treatment of qualifying holdings in commercial entities that exceed certain thresholds; and
- the reporting requirements be revised as above.

ISSUES FOR CONSIDERATION

Q2: THE FSRA INVITES COMMENTS ON ITS PROPOSALS TO USE TIER 1 AS THE DENOMINATOR FOR THE LE RATIO AND TO UPDATE THE REPORTING REQUIREMENTS FOR ITS LE FRAMEWORK.

(c) Disclosure requirements

26. Disclosure is at the core of Pillar 3 of the Basel Framework, complementing minimum capital requirements (Pillar 1) and supervisory review (Pillar 2), and is predicated on banks providing market participants with relevant, key information that allows them to assess effectively the capital adequacy of those banks. The existing disclosure requirements for Authorised Persons in prudential Categories 1, 2 and 5 are in large part a combination of the Basel II disclosure regime, as updated by Basel 2.5. Given the current state of development of the market in ADGM, and on the grounds of proportionality, we are proposing to revise the set of disclosure requirements for those Authorised Persons within its scope.

27. The proposed disclosure requirements would cover the following areas.

- Scope of application (to stay as currently reflected in PRU APP12, Table 1).
- Capital Resources (to stay as currently reflected in Table 2).
- Capital Adequacy (Table 3 to be revised) – an overview of the Total Risk Exposure Amount (TREA), and breakdowns across credit, market,

and operational risk types, supplemented by the Leverage Ratio and its components (capital and exposure measures).

- Liquidity Risk (Table 12 to be revised) – to stay as per current requirements for the LCR and its components (across available high quality liquid assets and cash outflows) and, if adopted, the proposals contained in Appendix 1 for the NSFR and its components (across available and required stable funding) to be added.

28. These revised disclosure requirements would apply to all Authorised Persons currently required to disclose the information detailed in APP12 of PRU. If these proposals were to be implemented, a Domestic Firm authorised after that date would become subject to the proposed disclosure requirements from the end of its first full financial year after receiving its FSP, albeit with supervisory discretion to bring forward or delay the disclosure requirements, based on the perceived benefits such disclosures might bring to other market participants.

Proposal

29. We are proposing that the disclosure requirements be revised in order to be proportionate to the risk profile of the existing population of Authorised Persons in ADGM.

ISSUES FOR CONSIDERATION	
Q3:	THE FSRA INVITES COMMENTS ON ITS PROPOSAL TO REVISE THE DISCLOSURE REQUIREMENTS.

(d) Miscellaneous amendments to PRU

30. There are a number of areas where we are proposing miscellaneous amendments for the purposes of providing greater clarity to Authorised Persons of the requirements that PRU places on them, alongside corrections where the existing text contains inconsistencies, errors or omissions. The most substantive of these proposed miscellaneous amendments are outlined here.

- Qualifying Holdings (PRU 3.14.1)
 - We are proposing that the current risk-weighting approach under (3)(a) is retained and the prohibition of having such holdings under (3)(b) is removed as this will allow Authorised Persons to choose whether they have such holdings, subject to having to risk-weight the excess(es).
 - Additionally, we are proposing that the greater of (i) the amount of individual holdings above the related threshold or (ii) the total amount of aggregate holdings in excess of the relevant threshold is subject to risk-weighting, i.e. one of them but not both; this will avoid the potential double-counting of minimum capital requirements and align with the corresponding requirements in CRD IV.
 - As noted above in paragraph 25, we propose introducing Tier 1 as the denominator for determining the level of excess(es) to be risk—weighted.
- Operational risk (PRU Chapter 6 and APP7)
 - Where historical data is not available (e.g. for start-ups) for the calculation of the minimum capital requirements, business estimates must be used in order to get three sets of annual data for the calculation.
- Credit Valuation Adjustment (PRU APP5)
 - In the interests of proportionality, we are proposing the introduction of a threshold of US \$100 billion for the aggregate notional amount of OTC Derivatives before this minimum capital requirement applies, subject to the CVA risk being assessed as not being material and the Authorised Person receiving the agreement of the FSRA that this is the case.

Q4: THE FSRA INVITES COMMENTS ON THE MISCELLANEOUS AMENDMENTS THAT ARE PROPOSED.

FUTURE DEVELOPMENTS IN BASEL

31. Further elements of Basel III remain to be implemented in ADGM in the future. Accordingly, we shall evaluate their appropriateness for implementation in future, in the light of the overarching objectives of ADGM and following public consultation as appropriate.

APPENDIX

Appendix 1 - PRU Updates