



ABU DHABI GLOBAL MARKET  
سوق أبوظبي العالمي

# CONSULTATION PAPER NO. 4 OF 2017

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30 OCTOBER 2017

**REVISION OF THE  
“PRUDENTIAL – INVESTMENT, INSURANCE  
INTERMEDIATION AND BANKING”  
RULEBOOK**

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## INTRODUCTION

### WHY ARE WE ISSUING THIS PAPER?

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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 regulatory prudential regime for investment, insurance intermediation and banking institutions in ADGM, contained in the Prudential – Investment, Insurance Intermediation and Banking Rulebook ("**PRU**").

### WHO SHOULD READ THIS PAPER?

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2. The proposals in this Consultation Paper should be of interest to institutions operating in the investment, insurance intermediation and banking sectors and their professional advisors.

### HOW TO PROVIDE COMMENTS

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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?

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4. The deadline for providing comments on these proposals is 7 December 2017. 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 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:**

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## BACKGROUND

1. ADGM FSRA has decided to update aspects of the prudential regime contained in PRU. The term “**firms**” will be used in the remainder of this consultation paper for the institutions falling within the scope of PRU and covers both Domestic Firms and Branches, as defined in the Glossary Rulebook (“**GLO**”). The proposals will align PRU more closely with the current regulatory prudential regime developed by the Basel Committee on Banking Supervision (“**BCBS**”) where it is necessary and appropriate to do so, as that regime provides internationally-recognised, transparent and robust prudential standards.
2. Following the global financial crisis the BCBS developed “Basel III”, published in 2011, which supplemented and reinforced the regime existing during the crisis, comprising “Basel II” (originally published in 2004) and “Basel 2.5” (2009). The existing, overall prudential regime, comprising the three frameworks (Basel II, Basel 2.5 and Basel III), will be referred to as “Basel” in the remainder of this consultation paper and qualified where necessary to identify one of the constituent frameworks.
3. Basel III was a response to shortcomings that had been identified in the regulatory prudential regime, covering both capital and liquidity, which was in place during the crisis. Identified limitations of the existing regime included the quantity and quality of capital resources, capital requirements, leverage and, additionally, liquidity/funding issues. The implementation of Basel III has been staggered, starting in 2013 and with its final aspects due to be implemented in 2019.
4. In ADGM the prudential regime adopted by FSRA for firms is largely based on Basel. Although Basel is strictly applicable only to banks and similar credit institutions, it underpins the overall prudential regime detailed in PRU, which also has investment firms within its scope, in a manner similar to the Capital Requirements Directive IV (“**CRD IV**”) in the European Union (“**EU**”).

5. FSRA has identified a number of aspects of Basel III that, according to the timetable for Basel III, were due to be implemented on or before 1 January 2017, but which are not currently reflected in PRU. This consultation paper presents proposals related to those aspects deemed to be appropriate for implementation in ADGM, with a planned implementation date of 1 January 2018 in ADGM. As a general principle, FSRA does not propose to implement at this stage any Basel III standards with a planned implementation date after 1 January 2017, as has been done in certain BCBS member jurisdictions. Any aspects of Basel III due for implementation after 1 January 2017 will be considered in future for implementation in ADGM as and when considered necessary and appropriate.
6. FSRA conducted a benchmarking exercise across a number of leading international jurisdictions that are subject to Basel III, including Hong Kong, Singapore and Australia, plus the EU where CRD IV is very largely based on Basel. This exercise has assisted FSRA in understanding the state of implementation in those jurisdictions, regarding those aspects of Basel III covered by the proposals in this consultation paper.
7. In addition to Basel III this paper also covers further proposals related to the following matters:
  - a. Updating the reporting requirements in PRU in the light of the recent implementation of the Electronic Prudential Reporting System (“EPRS”) in ADGM.
  - b. Reordering the existing Chapter 3 of PRU to provide a more logical progression through the requirements to be met by firms, starting with the calculation of risk exposure amounts and thereby determining the minimum capital resources required to meet them, also adding further guidance and providing supplementary material in PRU where this will provide clarity to firms.
  - c. Undertaking minor, consequential amendments to PRU in order to ensure consistency with the proposed amendments.

8. The proposed and consequential amendments to PRU are contained in Annex A, a mapping table associated with PRU 4.11 in Annex B and a list of abbreviations used in this paper in Annex C.

## REVISION OF THE REGULATORY PRUDENTIAL REGIME IN PRU

### KEY PROPOSALS

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9. The key proposals are:
  - a. instituting the Countercyclical Capital Buffer (“**CCyB**”);
  - b. requiring firms to meet the Leverage Ratio and disclose it publicly;
  - c. requiring firms to hold capital resources against potential credit valuation adjustment (“**CVA**”);
  - d. requiring the provisions governing capital instruments to make them available to absorb losses at the point of non-viability as determined by the appropriate authority, in order that they be considered eligible for inclusion in Additional Tier 1 (“**AT1**”) and Tier 2 (“**T2**”) capital resources;
  - e. introducing capital requirements for exposures to central counterparties (“**CCPs**”);
  - f. introducing the Standardised Approach for measuring counterparty credit risk (“**SA-CCR**”) that better evaluates counterparty credit risk and thereby the associated capital resources that must be held for it;
  - g. disclosure of the Liquidity Coverage Ratio (“**LCR**”); and
  - h. making miscellaneous amendments to PRU to remove certain Regulated Activities from prudential Category 4, address new reporting requirements, and provide further information and greater clarity to firms.

## (a) Countercyclical Capital Buffer

10. The CCyB is a second capital buffer, alongside the Capital Conservation Buffer (CCoB) that is already a requirement in PRU for firms falling into certain prudential categories, and is considered by the BCBS as an extension of the CCoB. In broad terms, it is a macro-prudential tool for jurisdictions that function as fully-fledged economies, designed to ensure that the cost of credit for exposures to the private sector in a jurisdiction is at a level that constrains credit growth where it is assessed to be significantly above the average historical rates of growth.
11. The CCyB aims to reflect the macro-financial environment in which firms operate, both in their home and other, external jurisdictions. It is designed to ensure that firms build up capital resources during normal macroeconomic circumstances that can be drawn down as the economy within that jurisdiction comes under stress and related losses are suffered.
12. The CCyB rate is designed to vary between 0% and 2.5%, as determined by the local rate-setting authority for a jurisdiction, of the total RWAs of a firm and must be met by Common Equity Tier 1 (“CET1”). The intention is that the rate would be increased by that authority as excessive credit growth is observed, in order to build up a buffer of capital resources to absorb potential losses that might later crystallise as a result of the economy coming under stress. Conversely, during a downturn a rate-setting authority may also reduce the rate to release to the firm those capital resources previously held as the CCyB.
13. The CCyB (and the CCoB) applies at the consolidated level, but host supervisors may also require buffers to be maintained at the level of solo entities to preserve capital resources in specific parts of the group. In the context of ADGM, therefore, it could be that a firm is not subject to a “local” CCyB for its operations within ADGM given the nature of its exposures, but may be required to hold capital resources for CCyBs imposed by other jurisdictions.

### *Within ADGM and the UAE*

14. ADGM is a jurisdiction that does not currently have what might be termed “an economy”, specifically in relation to the existence of the supply of credit to the private sector in ADGM by firms authorised in ADGM. The extent to which firms might be exposed to the consequences of excessive growth of credit supply to the private sector in ADGM is, therefore, not a meaningful consideration at this point in time.
15. However, it is recognised that firms authorised in ADGM may have exposures to the private sector elsewhere in the UAE and that the Central Bank of the UAE (CBUAE) may impose a non-zero CCyB rate for those exposures; additionally, in future such exposures may potentially exist within ADGM. For that reason we are proposing that the CCyB framework be implemented in ADGM and that the CBUAE be regarded as the CCyB rate-setting authority for the relevant categories of firms with potential private-sector exposures in ADGM and the UAE.
16. We also propose that firms in prudential Category 3A should be omitted from the scope of the CCyB and, additionally, we are proposing that they be removed from the existing scope of the CCoB as these buffers have been designed with banks in mind that have private-sector credit exposures so they are not relevant for the population of firms in that prudential Category.

### *Other jurisdictions*

17. Moreover, firms authorised in ADGM may be subject to one or more CCyBs imposed by other, non-UAE jurisdictions where they have private-sector credit exposures. In order to meet the Basel III standards for the CCyB we are also proposing therefore that the relevant categories of firms authorised in ADGM will be required to hold appropriate capital resources to satisfy CCyBs imposed by jurisdictions outside the UAE.

## ISSUES FOR CONSIDERATION

Q1: FSRA INVITES COMMENTS ON ITS PROPOSAL TO INTRODUCE A COUNTERCYCLICAL CAPITAL BUFFER FRAMEWORK.

### **(b) Leverage Ratio**

18. Basel III introduced a "Leverage Ratio" which is designed to limit the extent to which banks fund their assets using debt capital. This is to be achieved by ensuring that banks hold Tier 1 capital ("T1", comprising CET1 and AT1) of at least 3% of their assets, that ratio being calculated without any risk-weighting adjustments to those assets. The requirement to calculate the Leverage Ratio using the approach outlined in Basel III is already in PRU, applying only to Domestic Firms in prudential Categories 1, 2 or 5. Our proposal is that those firms must in future meet both the floor of 3% and disclose the Leverage Ratio on a quarterly basis.

## ISSUES FOR CONSIDERATION

Q2: FSRA INVITES COMMENTS ON ITS PROPOSAL TO REQUIRE A MINIMUM LEVERAGE RATIO TO BE MET AND FOR IT TO BE DISCLOSED.

### **(c) Credit Valuation Adjustment**

19. For OTC derivatives that are uncollateralized and uncleared the CVA is a capital requirement to guard against the component of potential losses in their mark-to-market value that relates to deteriorating counterparty creditworthiness (rather than the component arising from general market risk factors). Given the potential for significant losses to arise from this source we are proposing the introduction of a framework requiring firms to hold capital resources for this risk.

20. We recognize, however, that requiring a firm to develop a framework to collect the relevant data and undertake the calculation of the capital requirement may be disproportionate to the risks facing that firm where the part of its risk profile arising from these exposures is not material. Accordingly, if a firm believes this to be the case it should approach its supervisory contact and any application for a waiver will be considered on a case-by-case basis.

#### ISSUES FOR CONSIDERATION

Q3: FSRA INVITES COMMENTS ON ITS PROPOSAL TO INTRODUCE A FRAMEWORK COVERING THE CREDIT VALUATION ADJUSTMENT.

#### **(d) Point of Non-Viability**

21. Basel III requires the provisions governing all capital instruments qualifying as eligible AT1 or T2 capital resources to ensure those instruments' loss absorbency at the point of non-viability ("**PONV**"); this is accomplished through those instruments being written off or converted into CET1 at that point. The determination of the PONV is undertaken by the relevant authority charged with intervening to prevent or manage the failure of a firm, upon the occurrence of a trigger event. A valid trigger event in this context, as determined by the relevant authority, is considered to be the earlier of (i) a decision that such a write-off or conversion is necessary to prevent the firm becoming non-viable or (ii) a decision to make a public sector injection of capital or equivalent support without which the firm would become non-viable.
22. In relation to trigger event (ii) above, ADGM does not consider it appropriate to allocate resources to make a determination whether it is necessary to make such an injection of capital into a failing firm on an emergency basis, as it has neither tax-raising powers nor recourse to public funds to enable it to support a failing firm in that way. Given this, we are proposing that capital instruments

must have, as a condition for eligibility as AT1 and T2 regulatory capital resources, appropriate provisions to allow them to be written off or converted into CET1 where the relevant authority makes a decision that that such write-off or conversion is necessary to prevent the firm becoming non-viable.

23. We recognize, however, that firms may currently have capital instruments that qualify as eligible AT1 or T2 capital resources and do not contain the proposed contractual provision(s). Where this is the case and a firm wishes for those capital instruments to continue to be considered as eligible capital resources it should approach its supervisory contact and any application for a waiver will be considered.

#### ISSUES FOR CONSIDERATION

Q4: FSRA INVITES COMMENTS ON ITS PROPOSAL TO REQUIRE THE INCLUSION OF PROVISIONS RELATING TO PONV.

#### **(e) Central counterparties**

24. The treatment of the exposures of a firm to a CCP, whether as a clearing member of a CCP for its own purposes or where providing clearing services to a client, has been updated and expanded by Basel III. The revised framework better reflects those characteristics of the exposures of the firm that determine the related risk profile, including the following: the nature of the prudential supervision that a CCP is subject to in the jurisdiction in which it is based; current or future exposures to a CCP resulting from derivative trades; any posted collateral or exposures to the default funds of CCPs; and the existence of any multi-level client structures.
25. We propose introducing the updated framework in relation to CCPs as it is more comprehensive and risk-sensitive than the existing framework that is in PRU.

## ISSUES FOR CONSIDERATION

Q5: FSRA INVITES COMMENTS ON ITS PROPOSAL TO UPDATE THE FRAMEWORK FOR THE TREATMENT OF EXPOSURES TO CCPS.

### **(f) Counterparty credit risk**

26. The Standardised Approach to Counterparty Credit Risk (SA-CCR) for assessing the exposure at default for counterparty credit risk for OTC derivatives, exchange-traded derivatives and long settlement transactions, was developed under Basel III and replaces the existing, non-modelling approaches introduced as part of Basel II. The SA-CCR provides greater risk-sensitivity than the existing approach in PRU by differentiating across several dimensions of transactions (e.g. margined and unmargined, bilateral and cleared, the degree of netting present). Indeed, it is important to note that the CCP treatment mentioned above (and other elements of the Basel III framework such as CVA and Large Exposures) is dependent on a more sophisticated counterparty credit risk framework than the one that currently exists in PRU.
27. We are proposing implementation of the SA-CCR as a number of treatments in PRU, both existing and proposed (e.g. the Leverage Ratio and the treatment of exposures to CCPs respectively), are dependent on a more risk-sensitive counterparty credit risk framework than currently exists in PRU.

## ISSUES FOR CONSIDERATION

Q6: FSRA INVITES COMMENTS ON ITS PROPOSAL TO INCORPORATE THE SA-CCR FRAMEWORK IN ORDER TO INCREASE THE RISK-SENSITIVITY OF A NUMBER OF OTHER PRUDENTIAL FRAMEWORKS, BOTH EXISTING AND PROPOSED.

## **(g) Disclosure of the Liquidity Coverage Ratio**

28. Disclosure is one of the three complementary “Pillars” of the overall Basel framework, alongside minimum capital requirements and the supervisory process. A number of disclosure requirements arising from Basel III have already been implemented through PRU, and we are proposing that the LCR be disclosed by firms on a quarterly basis. Firms are already required to calculate the LCR and its disclosure will enable market participants to assess the ability of those firms to meet their potential liquidity needs over a thirty-day period during a stress event.

### **ISSUES FOR CONSIDERATION**

Q7: FSRA INVITES COMMENTS ON THE DISCLOSURE OF THE LCR BY FIRMS.

## **(h) Miscellaneous amendments to PRU**

29. There are a number of areas where we are proposing miscellaneous amendments in order to update PRU so that it provides firms with more information and therefore greater clarity of the requirements it places on them, and a summary of these proposals is given here.

- a. The following Regulated Activities currently fall into Category 4 for the purposes of prudential supervision, but do not have any prudential considerations arising from those activities, so will be removed from that Category.
  - Operating a Credit Rating Agency.
  - Operating a Representative Office.
  - Administering a Specified Benchmark.
  - Providing Information in Relation to a Specified Benchmark.

- b. For the purposes of regulatory reporting the Electronic Prudential Reporting System (EPRS) for FSRA was introduced in Q3 2017, with its associated taxonomy. Accordingly, reporting requirements in PRU will be updated to reflect this.
- c. Chapter 3 of PRU, covering primarily capital requirements and resources, will be reordered to present a more logical progression to the calculation of minimum capital resources that must be held.
- d. A mapping table to translate external credit ratings to a credit quality grades (and thereby to risk weightings) will be published as guidance for Domestic Firms to allow them to undertake the necessary mapping.
- e. Additionally, the treatment of free deliveries has been updated to reflect the Basel treatment.
- f. Further, explanatory text will be added to PRU where it will provide greater clarity, e.g. in respect of the importance of liquidity alongside capital.

#### ISSUES FOR CONSIDERATION

Q8: FSRA INVITES COMMENTS ON THE MISCELLANEOUS AMENDMENTS THAT ARE PROPOSED.

#### FUTURE DEVELOPMENTS IN BASEL

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30. There are further elements of the published Basel III framework remaining to be implemented in the future, plus the overall Basel prudential regime is undergoing further development in a number of related areas. We shall evaluate the relevance of these remaining elements as they come up for implementation and also consider future proposals emanating in Basel, including further disclosure requirements, as they are finalized. We shall consider whether their implementation in ADGM is warranted, in the light of the overarching objectives of ADGM and following public consultation as appropriate.