CENTRAL BANK OF THE U.A.E.

Guidance re Capital Supply

Introduction

This guidance explains how banks can comply with the standards of UAE capital supply. It must be read in conjunction with the Capital Regulation and Capital Standards. Guidance regarding Minimum Capital Requirement and Capital buffer as stated in the document have to be followed by all banks for the purpose of regulatory compliance.

To help and ensure a consistent and transparent implementation of Capital supply standard, CBUAE will review and update this guidance document periodically.

The guidance document has structured into six main sections

1. Scope of Application
2. Eligible capital
3. Regulatory adjustments
4. Threshold deductions
5. Significant investment in commercial entities
6. Frequently Asked Questions

1. Scope of Application

Financial activities" do not include insurance activities and "financial entities" do not include insurance entities.

Examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking

<u>Treatment of investment in Insurance Entities</u>

Insurance subsidiaries are to be deconsolidated for regulatory capital purposes (i.e. all equity, assets, liabilities and third-party capital investments in such insurance entities are to be removed from the bank's balance sheet) and the book value of the investment in the subsidiary is to be included in the aggregate investments.

Investments in the capital of insurance entities where the bank owns more than 10% of the insurance entity's common share capital will be subject to the "Threshold deductions" treatment. Amounts below the threshold that are not deducted are to be risk weighted at 250 %.
(*Investments in insurance entities wherein ownership is greater than 10% will also include insurance subsidiaries*)

2. Eligible capital

Accumulated other comprehensive income and other disclosed reserve

For unrealized fair value reserves relating to financial instruments to be included in CET1 capital banks and their auditor must only recognize such gains or losses that are prudently valued and independently verifiable (e.g. by reference to market prices). Prudent valuations, and the independent verification thereof, are mandatory.

The amount of cumulative unrealized losses arising from the changes in fair value of financial instruments, including loans/financing and receivables, classified as “available-for-sale” shall be fully deducted in the calculation of CET1 Capital.

Revaluation reserves or cumulative unrealized gains shall be added to CET 1 with a haircut of 55%.

The amount of cumulative unrealized gains arising from the changes in the fair value or revaluation of bank’s own premises and real estate investment are not allowed to be included as part of Asset Revaluation reserve for regulatory purposes.

IFRS9 will be implemented during 2018. Banks that are impacted significantly from the implementation of IFRS9 may approach the Central Bank to apply for a transition period for the IFRS9 impact. Such applications will be analysed and considered on a case-by-case basis.

Retained Earnings

The amount reported under accumulated retained earnings (5.1.4.1) should be as per the audited financial statement at year end and should remain the same for the entire financial year.

Current financial year’s/quarter’s profits can only be taken into account after they are properly audited/ reviewed by the external auditors of the bank. Current financial years /quarter’s loss if incurred have to be deducted from the capital..

Dividend expected/ proposed for the financial year should be reported under 5.1.4.3 and will be deducted from Retained Earnings/ (Loss) (5.1.4). Expected dividend applies only for Q4 until dividend is actually paid.

The dividend deduction must be updated based on each of the following events, if the amount changes, after Annual General meeting, or the approval from the CBUAE, or the release of the Financial Statements by the auditors.

Capita buffer - countercyclical buffer

Banks will have to look at the geographic location of their private sector credit exposures (including non-bank financial sector exposures) and calculate their countercyclical capital buffer requirement as a weighted average of the buffers that are being applied in jurisdictions to which

they have an exposure. Credit exposures in this case include all private sector credit exposures that attract a credit risk capital charge or the risk weighted equivalent trading book capital charges for specific risk and securitisation.

The weighting applied to the buffer in place in each jurisdiction will be the bank's total credit risk charge that relates to private sector credit exposures in that jurisdiction, divided by the bank's total credit risk charge that relates to private sector credit exposures across all jurisdictions.

The charge for the relevant portfolio should be allocated to the geographic regions of the constituents of the portfolio by calculating the proportion of the portfolio's total exposure at default (EAD) that is due to the EAD resulting from counterparties in each geographic region

3. Regulatory adjustments

Goodwill and Other Intangibles

Intangible assets typically do not generate any cash flows and hence their value, when a bank is in need of immediate additional capital to absorb losses, is uncertain. For this reason, all intangible assets are deducted from CET1 (5.1.8.1).

From regulatory perspective, goodwill and intangible assets have the same meaning as under IFRS.

Capitalized software costs that is not “integral to hardware” is to be treated as an intangible asset and software that is “integral to hardware” is to be treated as property, plant and equipment (i.e. as a fixed asset).

The amount of intangible assets to be deducted should be net of any associated deferred tax liability (DTL) that would be extinguished if the asset became impaired or derecognised under the applicable accounting standard.

Goodwill and intangible assets that are deducted from CET1, they are excluded from the calculation of RWA for credit risk exposure value.

Deferred Tax Assets

Deferred tax assets (DTAs) typically arise when a bank:

- suffers a net loss in a financial year and is permitted to carry forward this loss to offset future profits when calculating its tax bill (net losses carried forward)
- has to reduce the value of an asset on the balance sheet, but this 'loss in value' is not recognised by the tax authorities until a future period (temporary timing difference)

DTAs arising from net losses carried forward have to be deducted in full from a bank's CET1 (5.1.8.2). This recognises that their value can only be derived through the existence of future taxable income. On the other hand, a DTA arising from temporary timing differences is subject to the 'threshold deduction rule' (5.1.9.2).

4. Threshold Deduction

The purpose of calculating the threshold is to limit the significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities) and deferred tax assets (arising from temporary differences) to 15% of the CET1 after all deduction (Deduction includes regulatory deductions and the amount of significant investments in the common shares of unconsolidated financial institutions and deferred tax assets in full).

Therefore, significant investments in the common shares of unconsolidated financial institutions and deferred tax assets may receive limited recognition of 10% CET1 individually (CET after regulatory adjustment section 3 of capital standard)

The amount that is recognised will receive risk weight of 250% and the remaining amount will be deducted.

See annex 5 for an example.

5. Significant investment in commercial entities.

For purposes of this section, 'significant investments' in a commercial entity is defined as any investment in the capital instruments of a commercial entity by a bank which is equivalent to or more than 10% of CET 1 of the bank (after application of regulatory and threshold deduction). See Annex 3 for an example.

6. Frequently Asked Questions

Q1: When will the Standard, Guidance and Template with regards to Solo reporting be issued by the CBUAE?
The CBUAE will issue all related material regarding Solo reporting during 2018. Formal communication will be issued in advance.

Q2: What is meant by the book value of an investment?
The book value of an investment shall be in accordance with the applicable accounting framework (IFRS). This valuation must be accepted by an external auditor.

Q3: Are capital shortfalls of non-consolidated insurance companies to be deducted from CET1?
Yes, any capital shortfall on a company has to be deducted.

Q4: If the Bank meets minimum CET1 ratios can the excess CET1 also be counted to meet AT1 and Total CAR?
Yes.

Q5: Please clarify whether minority interest related to any other regulated financial entity (which is not a bank) should be included or not.
Only minority interest of the subsidiary that are subject to the same minimum prudential standards and level of supervision as a bank be eligible for inclusion in the capital.

Q6: Is the bank able to include the profit & loss in the yearend CAR calculation before the issuance of the audited financial statements?
Bank may include interim profit/ yearend profit in CET1 capital only if reviewed or audited by external auditors. Furthermore, the expected dividend should be deducted in Q4.

Q7: Is subordinated Debt currently considered Tier 2 as per Basel III, hence no amortization is required?
Grandfathering rule plus amortization in last 5 years - refer to paragraph 28 (iv)(b). Reference should also be made to the Capital Issuance Standard.

Q8: Do dividends need to be reduced from CET1 after the proposal from the Board or after CBUAE approval or after approval from shareholders at the Annual General Meeting?
Please refer to Question 6

Q9: How do you treat goodwill and intangible assets arising on an insurance subsidiary? Should it be considered since the standard mentions insurance subsidiaries are to be completely deconsolidated and hence there will be no goodwill?

Goodwill and other intangible must be deducted in the calculation of CET1. In particular deduction is also applied to any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of consolidation.

Q10: Subsidiaries which are used for providing manpower services at cost, should these be classified as commercial entities or financial entities?

A non-financial sector entity is an entity that is not:

a) a financial sector entity; or
b) a direct extension of banking; or
c) ancillary to banking; or
d) leasing, factoring, the management of unit trusts, the management of data processing services or any other similar services"

Q11: Obtain an understanding to the timeline by when the CBUAE may advise specific Banks of specific countercyclical buffers?

The underlying process for the implementation of countercyclical buffers will be set and communicated during 2018

Q12: Criterion 4 for Additional Tier 1 capital. Can the CBUAE give additional guidance on what will be considered to be an incentive to redeem?

The following list provides some examples of what would be considered to be an incentive to redeem:

A call option combined with an increase in the credit spread of the instrument if the call is not exercised.

A call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised.

A call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (ie the fixed rate paid to the call date to receive the second reference rate). For example, if the initial reference rate is 0.9%, the credit spread over the initial reference rate is 2% (ie the initial payment rate is 2.9%), and the swap rate to the call date is 1.2%, a credit spread over the second reference rate greater than 1.7% (2.9-1.2%) would be considered an incentive to redeem.

Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem. However, as required by criteria 5, the bank must not do anything that creates an expectation that the call will be exercised.

The above is not an exhaustive list of what is considered an incentive to redeem and so banks should seek guidance from CBUAE on specific features and instruments. Banks must not expect CBUAE to approve the exercise of a call option for the purpose of satisfying investor expectations that a call will be exercised.

Q13: Criteria 4 and 5 for Additional Tier 1 capital. An instrument is structured with a first call date after 5 years but thereafter is callable quarterly at every interest payment due date (subject to supervisory approval). The instrument does not have a step-up. Does instrument meet criteria 4 and 5 in terms of being perpetual with no incentive to redeem?

Criterion 5 allows an instrument to be called by an issuer after a minimum period of 5 years. It does not preclude calling at times after that date or preclude multiple dates on which a call may be exercised. However, the specification of multiple dates upon which a call might be exercised must not be used to create an expectation that the instrument will be redeemed at the first call date, as this is prohibited by criterion.

Q14: Can an option to call the instrument after five years but prior to the start of the amortisation period viewed as an incentive to redeem?

No, it can't be viewed as an incentive to redeem.

Annex 1: Banking, Securities, insurance and other financial entities - Significant investment (ownership in the entity more than 10%)

Significant investment (ownership in the entity more than 10%)					
Entity	Entity activity	Investment Classification	Listed/ Unlisted	Bank's ownership in the entity (% of Holding)	Investment Amount
A	Banking	Banking Book	Listed	40%	60
B	Insurance	Banking Book	Listed	18%	35
C	Securities	Banking Book	Unlisted	16%	28
D	Banking	Trading Book	Listed	11%	18
a.Total significant investment (Banking, Securities, insurance and other financial entities)					141
b. Bank's CET1 (after applying all the regulatory deduction except section 3.9 and 3.10)					1000
c. Limit (10 % of bank's CET1)					100
d. Amount to be deducted from bank's CET1					41
e. Amount not deducted to considered for aggregate threshold deduction					59

The remaining amount of 59 is to be distributed amongst the investments on a pro rata / proportionate basis and risk weighted at 250% (assuming no threshold deduction apply).The total of 187.50 RWA (59 *250%) will be distributed as follows.

Enity	Investment Classification	Investment Amount	as a % of all such invest ment	Calculation of amount not deducted to be risk weighted	Risk weight	RWA	Section
A	Banking Book	60	42%	24.78 (59 x 42%)	250%	61.95	Credit Risk
B	Banking Book	35	25%	14.75 (59 x 25%)	250%	36.87	Credit Risk
C	Banking Book	28	20%	11.80 (59 x 20%)	250%	29.50	Credit Risk
D	Trading Book	18	13%	7.67 (59 x 13%)	Equity Risk - Market risk section		
		141	100%	75			

Entity	Investment Classification	Investment Amount	as a % of all such investment	Calculation of amount not deducted to be risk weighted	Risk weight	RWA	Section
A	Banking Book	60	43%	31.91 (75 x 43%)	250%	78.75	Credit Risk
B	Banking Book	35	25%	18.62 (75 x 25%)	250%	46.88	Credit Risk
C	Banking Book	28	20%	14.89 (75 x 20%)	250%	37.5	Credit Risk
D	Trading Book	18	13%	9.57 (75 x 13%)	Equity Risk - Market risk section		
		141	100%	75			

Annex 2: Banking, Securities, insurance and other financial entities - Investment with ownership not more than 10%

Investment (ownership not more than 10%)					
Entity	Entity activity	Investment Classification	Listed/ Unlisted	Bank's ownership in the entity (% of Holding)	Investment Amount
E	Banking	Banking Book	Listed	10%	50
F	Banking	Trading Book	Listed	3%	11
G	Securities	Banking Book	Unlisted	8%	40
H	Insurance	Banking Book	Listed	2%	9
a.Total investment (Banking, Securities, insurance and other financial entities)					110
b. Bank's CET1 (after applying all the regulatory deduction except section 3.9 and 3.10)					1000
c. Limit (10% of bank's CET1)					100
d. Amount to be deducted from bank's CET1 (a-c)					10
e. Amount not deducted to be risk weighted (Remaining amount) (a-d)					100

The remaining amount of 75 is to be distributed amongst the investments on a pro rata / proportionate basis and risk weighted as stated below

Entity	Investment Classification	Investment Amount	as a % of all such investment	Calculation of amount not deducted to be risk weighted	Listed/ Unlisted	Risk weight	RWA	Section
E	Banking Book	50	45.5%	45.50 (100 x 45.5 %)	Listed	100%	34.50	Credit Risk
F	Trading Book	11	10.0%	10 (100 x 10.00%)	Listed	Equity Risk - Market risk section		
G	Banking Book	40	36.4%	36.4 (100 x 36.4%)	Unlisted	150%	40.50	Credit Risk
H	Banking Book	9	8.2%	8.2 (100 x 8.2%)	Listed	100%	6.00	Credit Risk
		110	**100%**	**100**				

Annex 3: Significant investments in commercial entities.

Individual Investment Limit Check and its treatment	
Bank's CET1 (after applying all the regulatory and threshold deduction)	1000
Individual Limit (10% of bank's CET1D)	100

Step 1: Individual Limit check

Significant investments in commercial entities								
Entity	Entity activity	Investment Classification	Listed/ Unlisted	Investment Amount	Amount as a % of bank's CET1	Significant Investment	Amount to RW at 952%	Remaining amount
I	Commercial	Banking Book	Listed	140	14%	Yes	40	100
J	Commercial	Banking Book	Listed	120	12%	Yes	20	100
K	Commercial	Banking Book	Unlisted	110	11%	Yes	10	100
L	Commercial	Banking Book	Listed	115	12%	Yes	15	100
M	Commercial	Banking Book	Listed	75	8%	No		75
N	Commercial	Banking Book	Listed	45	5%	No		45
O	Commercial	Banking Book	Listed	50	5%	No		50
				655			85	570

Risk weighting at 952% on account of 10% threshold on individual basis is 85.

Step 2: Aggregate Limit check

Aggregate of remaining amount of investments after 10% deduction (entity I,J,K,L,M,N & O)	570
Aggregate Limit (25% of bank's CET1)	250
The amount to be risk-weighted at 952% based on the 25% threshold on aggregate basis	250
Remaining amount of investments to be risk-weighted under the applicable risk weighting rules (100% RW for listed and 150% unlisted)	320

Total amount to be risk weighted at 952%: 335 (85 + 250)

Annex 4: Minority interest illustrative example

This Annex illustrates the treatment of minority interest and other capital issued out of subsidiaries to third parties, which is set out section 2.7 (Paragraph 35 to 43).

A banking group consists of two legal entities that are both banks. Bank P is the parent, Bank S is the subsidiary, and their unconsolidated balance sheets are set out below

Bank P Balance sheet	**Amount (AED)**	**Bank S Balance sheet**	**Amount (AED)**
Assets		**Assets**	
Loan to customers	100	Loan to customers	150
Investment in CET 1 of Bank S	7		
Investment in AT1 of Bank S	4		
Investment in T2 of Bank S	2		
Total Assets	**113**	**Total Assets**	**150**
Liabilities and Equities		**Liabilities and Equities**	
Depositors	70	Depositors	127
Common Equity (CET1)	26	Common Equity (CET1)	10
Additional Tier1 (AT1)	7	Additional Tier1 (AT1)	5
Tier 2	10	Tier 2	8
Total Liabilities and Equities	**113**	**Total Liabilities and Equities**	**150**

The balance sheet of Bank P shows that in addition to its loans to customers, it owns 70% of the common shares of Bank S, 80% of the Additional Tier 1 of Bank S and 25% of the Tier 2 capital of Bank S. The ownership of the capital of Bank S is therefore as follows:

Capital issued by Bank S			
	Amount Issued to Parent	**Amount Issued to third party**	**Total**
Common Equity (CET1)	7	3	10
Additional Tier1 (AT1)	4	1	5
Tier 1	11	4	15
Tier 2	2	6	8
Total Capital (TC)	13	10	23

The consolidated balance sheet of the banking group is set out below:

Consolidated Balance sheet of Bank P	
Assets	**Amount (AED)**
Loan to customers	250
Total Assets	250
Liabilities and Equities	
Depositors	197
Common Equity (CET1)	26
Additional Tier1 (AT1)	7
Tier 2	10
Minority Interest	
Common Equity (CET1)	3
Additional Tier1 (AT1)	1
Tier 2	6
Liabilities and Equities	**250**

For illustrative purposes, Bank S is assumed to have risk-weighted assets of 100. In this example, the minimum capital requirements of Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any loans to Bank P. This means that it is subject to the following minimum plus capital conservation buffer requirements and has the following surplus capital:

Minimum and surplus capital of Bank S		
Capital	Minimum plus Capital conservation Buffer	Surplus
CET1	(7% + 2.5%) of 100 = 9.5	0.50 (10- 9.5)
T1	(8.5%+ 2.5%) of 100 = 11	4.00 (10+5-11)
TC	(10.5% +2.5%) of 100 = 13	10 (10+5+8 -13)

The following table illustrates how to calculate the amount of capital issued by Bank S to include in consolidated capital, following the calculation procedure set out in paragraphs 35 to 43.

Bank S: amount of capital issued to third parties included in the consolidated capital.					
Capital	Total Amount Issued (A)	Total Amount Issued to third party (B)	Surplus (C)	Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (D) = (C) * (B/A)	Amount Included in the consolidated capital (E) = (B)-(D)
CET1	10	3	0.5	0.15	2.85
T1	15	4	4	1.07	2.93
TC	23	10	10	4.35	5.65

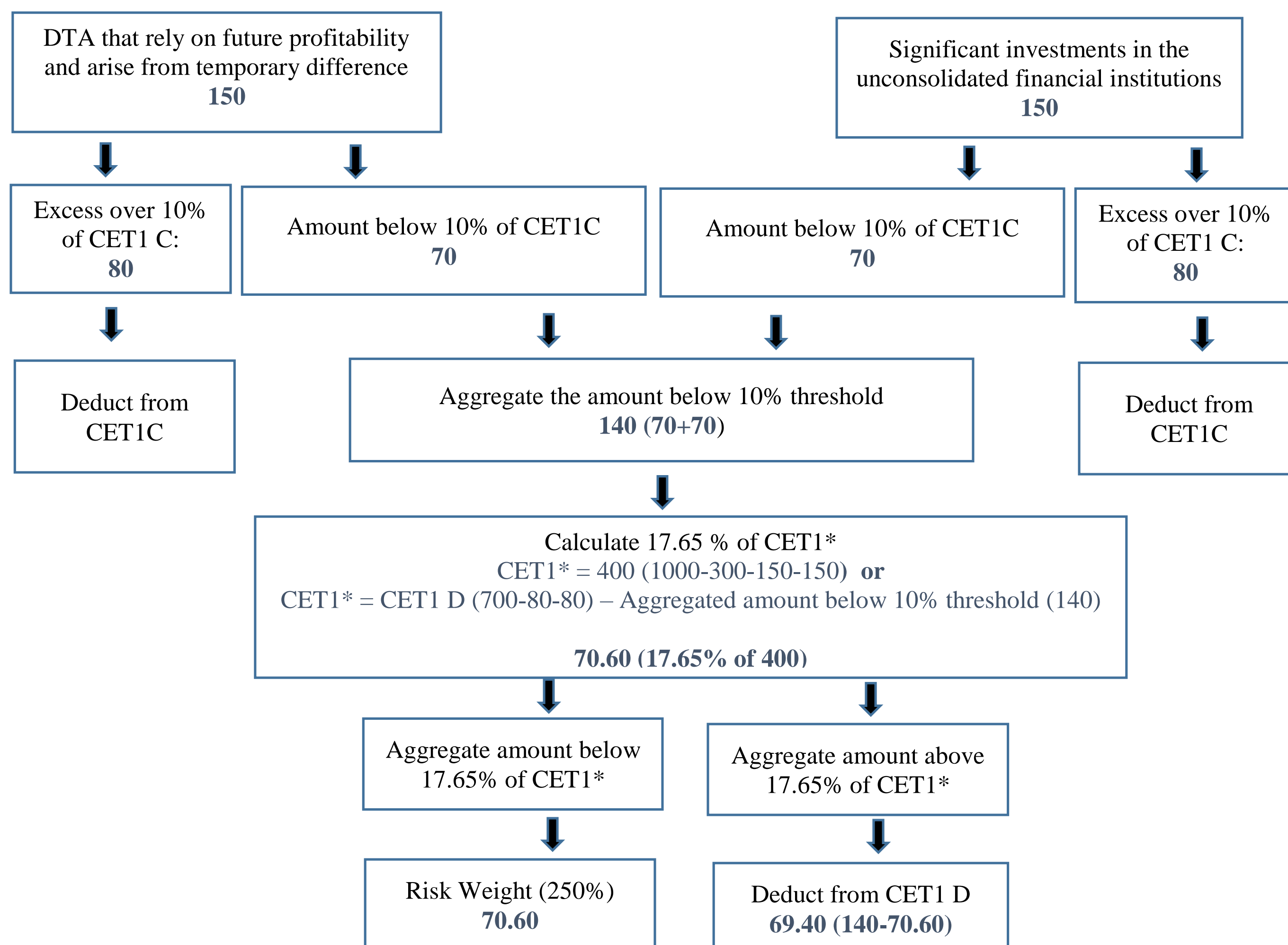
The following table summarizes the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between Common Equity Tier 1 and Tier 1 and Tier 2 is the difference between Total Capital and Tier 1.

Bank S: amount of capital issued to third parties included in the consolidated capital.			
Capital	Total amount issued by Parent (all of which is to be included in consolidated capital)	Amount issued by subsidiaries to third parties to be included in the consolidated capital	Total amount of capital issued by parent and subsidiary to be included in the consolidated capital
CET1	26	2.85	28.85
AT1	7	0.08	7.08
T1	33	2.93	35.93
T2	10	2.72	12.72
TC	43	5.65	48.65

Annex 5: Threshold Deduction

This annex is meant to clarify the reporting of threshold deduction and calculation of the 10% limit on significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); and the 10% limit on deferred tax assets arising from temporary differences.

CET1 Capital (prior to regulatory deductions)	1000
Regulatory deductions:	300
Total CET1 after the regulatory adjustments above (CET1C)	700
Total amount of significant investments in the common share of banking, financial and insurance entities	150
Total amount of Deferred tax assets arising from temporary differences	150



*This is a “hypothetical” amount of CET1 that is used only for the purpose of determining the deduction of above two items for the aggregate limit. Amount of CET1 = Total CET1 (prior to deduction) – All the deduction except the threshold deduction (i.e. all deduction outlined in para

44 to 67) minus the total amount of both DTA that rely on future profitability and arise from temporary difference and significant investments in the unconsolidated financial institutions.

Annex 6: Effective Countercyclical Buffer

Assume a bank has the following capital ratios

Capital Base	Minimum Capital Requirements	Bank's Capital Ratio
Common Equity Tier 1 Capital Ratio	7.00%	9.50%
Tier 1 Capital Ratio	8.50%	0.00%
Tier 2 Capital Ratio	2.00%	4.00%
Total Capital Ratio	10.50%	13.50%

From the above table, the bank has fulfilled all minimum capital requirements. In addition, the bank has to meet the additional capital buffers:

Capital Conservation Buffer (CCB)	2.50%
Countercyclical Buffer	0.00%
D- SIB	1.00%
Aggregated Buffer requirement (effective CCB)	**3.50%**

The table below shows the adjusted quartiles accordingly:

Freely available CET 1 Ratio	**Minimum Capital Conservation Ratios** (expressed as a percentage of earnings)
Within 1st quartile of buffer: **0.0 % - 0.875%**	100 %
Within 2nd quartile of buffer: **> 0.875% - 1.75%**	80 %
Within 3rd quartile of buffer: **> 1.75% - 2.625%**	60 %
Within 4th quartile of buffer: **> 2.625% - 3.5%**	40 %
Above top of the buffer: **> 3.5%**	0 %

As the bank does not have Additional Tier 1, the bank has to use 8.5% of its available CET1 to fulfill the minimum Tier 1 requirement of 8.5%. Only the proportion of CET1 that is not allocated to fulfill the minimum capital requirements is freely available to fulfill the buffer requirement. For this bank, 1% CET1 is freely available, because the bank already used 8.5% of its CET1 to fulfill the Tier 1 ratio. (9.5% available CET1 - 8.5% CET1 required to fulfill the Tier 1 minimum requirement of 8.5%).

Impact: The bank breaches the effective CCB with 1% freely available CET1. Capital conservation is required by at least 80% of the bank's earnings. Distributions to shareholders is limited to maximal 20% of the bank's earnings (CBUAE approval of dividends still required).