Proposed Changes in the Capital and Liquidity Requirements for Banks in UAE

by Sakshi Puri - s.puri@tamimi.com - Dubai International Financial Centre
Gaurav Jain - g.jain@tamimi.com -

September 2014

The UAE Central Bank has recently released the Financial Stability Report, 2013 (the "Report").

The Report analyses the domestic financial & economic performance over the last financial year. Furthermore, it proposes revisions to the existing prudential framework in line with the international developments and guidelines issued by the Basel Committee on Banking Supervision (the "Basel Committee") in 2010 (as revised) (the "Basel III Guidelines").

This article considers the potential impact of the Report (and by extension the Basel III guidelines) upon banks in the UAE.

Importantly, the Report provides that:

1. the new capital regime will be aligned with the Basel III Guidelines on capital adequacy and will include requirements for enhanced capital in terms of quality and quantity and the application of a new leverage ratio;
2. the definition of capital will change with more emphasis on paid-up capital, retained earnings and disclosed reserves; and
3. the UAE Central Bank is currently in the process of finalising new liquidity regulations for banks operating in the UAE which emphasise on the need for each bank to have a proper liquidity risk management framework in place to minimise the likelihood of liquidity stress and also minimise the impact on the bank should a stress occur.

The capital and liquidity rules constitute just one of the three "pillars" (i.e. Pillar 1) of the Basel framework. We consider the proposed changes in further detail below.

New Capital Regime

Changes in Capital

The Basel III Guidelines maintains the amount of minimum capital required at 8% of risk weighted assets. However, Basel III makes two significant changes (in addition to the changes in the assessment of trading risk). First, it has changed what constitutes 'capital' and, second it has introduced new capital buffers to supplement the minimum capital requirements.

Capital requirements under Basel III Guidelines are based on a hierarchy of capital instruments and in descending order the hierarchy is: (a) Core Tier 1 (which can absorb losses on a going concern basis), (b) Additional Tier 1; and (c) Tier 2 capital (which can absorb losses on a gone concern basis i.e. ensure that the depositors and senior creditors are repaid if an institution fails).

The total amount of Tier 1 capital now required under Basel III Guidelines is 6% out of which Core Tier 1 is required to be 4.5% (against the Basel II requirement of 2%). The Core Tier 1 can consist of ordinary share capital and retained earnings. The Additional 1.5% Tier 1 capital may consist of ordinary shares / retained earnings (if the bank so chooses), but other instruments are permitted to make up the difference. The criteria for inclusion in Core Tier 1, Additional Tier 1 and Tier II are detailed in the Basel III Guidelines. At present the minimum capital requirement in the UAE is 12% and Tier 2 capital under the UAE Central Bank rules can only be a maximum of 67% of Tier 1 capital. Considering that many of the UAE local banks already have high level of capital adequacy, the Basel III changes may not substantially impact the requirements of capital profile of the local banks.

New Leverage Ratio

Basel III introduces a non-risk weighted capital test as a supplementary to the risk based regulatory capital requirements and proposes a backstop non-risk weighted leverage ratio of 3%. This means a bank must hold equity equivalent to 3% of the value of the bank's assets (not risk weighted assets and including both on and off-balance sheet assets)). According to the Basel Committee, the leverage ratio is intended to constrain excess leverage in the banking system and provide an extra layer of protection against model risk and measurement error. Under the present Basel III Guidelines the leverage ratio would become a part of the capital rules under Pillar 1 in January 2018.

Introduction of capital buffers

A capital buffer is a capital requirement that sits on top of the minimum capital requirements. Breach of the minimum capital rules means the bank's licence to operate is in jeopardy – unless the required minimum is restored very quickly. Non-compliance with a buffer means that the bank may be restricted in the distributions it may make (whether to shareholders or to employees by way of bonuses) until earnings retained by the bank (or fresh capital) have restored the buffer.

The Basel III Guidelines has introduced two buffers: (a) 2.5% Core Tier 1 Capital Conservation Buffer (CCB); and (b) Counter-Cyclical Capital Buffer (CCCB) which operates only when a (national) regulator decides to impose it and it may be set at any level up to 2.5% Core Tier 1. CCB is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred whereas CCCB can be construed as a macro-prudential tool, which is designed to constrain lending by banks during an economic up-turn and to be left with (national) regulators to impose in economic up-swings.

Further the Basel III Guidelines also proposes a Globally Systemically Important Bank (G-SIB) capital surcharge and requires additional Core Tier 1 capital between 1% to 3.5% for such G-SIBs. The criteria to determine a G-SIB includes the size, interconnectedness, complexity, scale of cross-border operations and the non-substitutability of the services provided by a bank.

New Liquidity Regime

Until the Basel III Guidelines, liquidity standards were a matter for national regulators. The Basel III Guidelines now proposes two liquidity constraints on a bank's portfolio: (a) the Liquidity Coverage Ratio (LCR); and (b) the Net Stable Funding Ratio (NSFR). The former is designed to promote banks' short-term resilience to liquidity shocks, whilst the latter is designed to address liquidity mismatches and aims to give banks an incentive to fund themselves on an on-going basis with more stable sources of funding. The UAE Central Bank has under the Report at Chapter 6 provided a brief overview of certain macro-prudential tools including the LCR and NSFR. It is not expected that this will affect any domestic UAE banks.

The LCR requires banks to hold a stock of high quality liquid assets (HQLA) (i.e. cash or assets which can be converted into cash in private markets with little loss of value even in a period of stress) which is at least equivalent to the likely net cash outflows from the bank over 30 days in a stressed scenario. The Basel III Guidelines also details the requirements for HQLA and further recognises that national supervisors in jurisdictions in which Shari'ah compliant banks operate have the discretion to define Shari'ah compliant financial products (such as Sukuk) as alternative HQLA applicable to such banks only, subject to such conditions that the supervisors may require. The need for alternative HQLA for Shari'ah compliant banks is recognised by the Basel Committee as it may be difficult for such banks to meet the LCR requirement considering the prohibition on holding certain types of assets, such as interest-bearing debt securities. Under the Basel III Guidelines, the LCR is planned to be introduced on 1 January 2015 with a minimum requirement of 60% and will rise in equal annual steps of 10% to reach 100% on 1 January 2019.

The NSFR has not yet been definitively adopted, but its objective is to discourage banks from relying heavily on short-term funding from the wholesale markets. This ratio focuses on the notion of 'stable funding' and requires banks to have available stable funding at least equivalent to its required stable funding over a one-year time period. Under the Basel III Guidelines, the NSFR is only to be introduced in 2018.

Conclusions

The Central Bank proposals to implement Basel III Guidelines capital and liquidity regime may bring significant changes in the capital and liquidity requirements of banks in the UAE. The timeframe for complete implementation of the new capital regime under the Basel III Guidelines is 2019 and the Central Bank intends to begin the engagement process with banks towards implementing the new capital regime, including consultation on new regulations, in the second half of 2014. The Central Bank has also mentioned in the Report that timescales for implementation of the liquidity standards will be in line with those set up by Basel III Guidelines and the Central Bank expects to issue liquidity regulations in the second half of 2014. Whilst many other jurisdictions have already started adopting the Basel III Guidelines, the publication of the Report represents an important step by the Central Bank in this direction.