مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

Standard re Capital Supply

1. Scope of Application

1. The Capital Adequacy Regulation (circular no.52/2017) and the Capital Supply standards are applicable to all banks regulated by the CBUAE at both a solo level and group level.

   i. The solo level capital adequacy ratio requirements, which measure the capital adequacy of an individual bank based on its standalone capital strength (i.e. parent bank with branches in the U.A.E and its international branches); and

   ii. The group level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its capital strength and risk profile after regulatory consolidation of assets and liabilities of its banking group entities.

2. This standard formulates capital adequacy requirements to be applied on all banks in UAE on a consolidated basis. The consolidated entity includes all subsidiaries except insurance subsidiaries and commercial entities. The standard and the template on the solo reporting will be published at a later stage of the Basel project.

3. Additionally, banks are required to deduct, from CET1, the full amount of any capital shortfalls of subsidiaries that are regulated entities and are subject to capital requirements. The amount of the capital requirement and capital shortfall for this deduction is to be based on the guidelines issued by the subsidiary's regulator (i.e. based on host regulator's capital adequacy requirements).

4. This document must be read in conjunction with the Guidance Note for the Capital Supply.

1.1 Investments in the capital of Banking Subsidiaries

5. For the purpose of consolidated capital adequacy requirements, all banking and other relevant financial activities[1] (both regulated and unregulated) conducted within a banking group will be captured through consolidation to the greatest extent possible.

6. In instances where it is not feasible to consolidate certain majority owned banking, securities or other regulated financial entities[2], banks may, subject to prior CBUAE approval, opt for non-consolidation of such entities for regulatory capital purposes.

7. For group level reporting, if any majority-owned financial subsidiaries are not consolidated for capital purposes, all assets, liabilities and third-party capital investments in the subsidiaries will be removed

[1] "Financial activities" do not include insurance activities and "financial entities" do not include insurance entities.

[2] 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.

from the bank's balance sheet. All equity and other investments in regulatory capital instruments in those entities attributable to the bank / banking group will be deducted.

8. Banks are required to deduct, from CET 1, the full amount of any capital shortfalls of unconsolidated subsidiaries that are regulated entities and are subject to capital requirements. The amount of the capital requirement and capital shortfall for this deduction is to be based on the guidelines issued by the subsidiary's regulator (i.e. based on host regulator's local capital adequacy requirements).

1.2 Investments in the capital of banking, securities, financial and insurance entities

Banking, securities, financial and insurance entities – (ownership in entity is up to 10%)

9. Investments in banking, securities and other financial entities are defined as investments in the capital of banking, securities and other financial entities wherein the bank owns up to 10% of the investee's common share capital.

For detailed treatment of investments in such entities, refer Regulatory Adjustment (3.9) section.

Banking, securities, financial and insurance entities – Significant investments (ownership in entity is more than 10%)

10. Significant investments in banking, securities and other financial entities are defined as investments in the capital of banking, securities and other financial entities (that are outside the scope of regulatory consolidation) wherein the bank owns more than 10% of the investee's common share capital. Such investments will be subject to the treatment outlined in Regulatory Adjustment section (3.10).

1.3 Investments in Commercial Entities

11. Significant investments in commercial entities are to subject to the treatment outlined in section (5). Subsidiaries that are commercial entities are not to be consolidated for regulatory capital purposes. In cases where a subsidiary that is a commercial entity has been consolidated for accounting purposes, the entity is to be deconsolidated for regulatory capital purposes (i.e. all assets, liabilities and equity will be removed from the bank's balance sheet) and the book value of the investment will be subject to the treatment.

For detailed treatment of investments in such entities, refer Section (5).

2. Eligible capital under Basel III

2.1 Component of capital

12. Total regulatory capital will consist of the sum of the following item:

- i. Tier 1 capital , composed of
  - a. Common Equity Tier 1 (“CET1”)
  - b. Additional Tier 1 (“AT1”)
- ii. Tier 2 capital.

The above regulatory capital components are net of regulatory adjustments.

13. In accordance with Article (2.2) of Capital Adequacy Regulation requires the banks must apply the following minimum requirement, at all times:

- i. CET1 capital must be at least 7.0% of risk-weighted assets (RWA).
- ii. Tier 1 capital must be at least 8.5% of RWA.
- iii. Total capital, calculated as sum of Tier 1 capital and Tier 2 capital, must be at least 10.5% of RWA.

2.2 Capital Buffers:

14. In accordance with Article (5.1) of Capital Adequacy Regulation requires that banks must maintain a capital conservation buffer (CCB) of 2.5% of RWA in the form of CET1 capital.

15. In accordance with Article (6) of Capital Adequacy Regulation requires that banks may be required to implement a countercyclical buffer (CCyB). Banks must meet the CCyB requirements by using CET1 capital. Banks will be subject to a countercyclical buffer that varies between zero and 2.5% to total risk weighted assets. The buffer that will apply to each bank will reflect the geographic composition of its portfolio of credit exposures. The CCyB buffer extends the capital conservation buffer (CCB).

16. Domestic Systemically Important Banks (D-SIBs) are required to apply in accordance with article (7) of the Capital Adequacy Regulation. The additional requirements for identified D-SIBs will be communicated individually by the Central Bank to each relevant bank. Banks must meet the D-SIB buffer requirements by using CET1 capital. The D-SIB buffer extends the capital conservation buffer (CCB).

17. Based on the outcome of the Supervisory Review and Evaluation Process (SREP) conducted by the Central Bank, a bank may be subject to an additional capital add-on, also referred to as individual Supervisory Capital Guidance requirement (SCG). Banks notified must apply the individual SCG requirement, as set by the Central Bank. The Individual SCG increases the minimum CET1 requirement.

18. The aggregation of all the capital buffers (CCB, CCyB and D-SIB) form an effective capital conservation buffer. Any breach of the capital conservation buffer will lead to the following additional supervisory requirements and constraints on distributions:

i. Bank must immediately inform CBUAE
ii. Bank shall submit an approved plan to restore its regulatory capital level to meet the buffer requirement
iii. Tighter Supervision
iv. Capital conservation (“restriction of dividends)

2.3 Common Equity Tier 1

19. CET1 capital consists of the sum of the following elements:

i. Common shares issued by a bank which are eligible for inclusion in CET1 (or the equivalent for non-joint stock companies);
ii. Share premium resulting from the issue of instruments included in CET1;
iii. Retained earnings;
iv. Legal reserves;
v. Statutory reserves;
vi. Accumulated other comprehensive income and other disclosed reserves;
vii. Common shares issued by consolidated subsidiaries of a bank and held by third parties, also referred to as minority interest, which are eligible for inclusion in CET1;
viii. Regulatory adjustments applied in the calculation of CET1.

20. Retained earnings and other comprehensive income include audited/reviewed interim profit or loss. Expected dividends are removed from Common Equity Tier 1.

Common shares issued by the bank

21. For an instrument to be included in CET1 capital, it must meet all of the following criteria stated below. In cases where banks issue non-voting common shares, they must be identical to voting common shares of the issuing bank in all respects except the absence of voting rights for inclusion in CET1.

i. Represents the most subordinated claim in liquidation of the bank.
ii. The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been paid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
iii. The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law and subject to the prior approval of the CBUAE.
iv. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature that might give rise to such an expectation.

v. Distributions are paid out of distributable items, including retained earnings. The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
vi. There are no circumstances under which the distributions are obligatory. Non-payment is, therefore, not an event of default.
vii. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
viii. The issued capital takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.
ix. The paid in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency.
x. The paid in amount is classified as equity under the relevant accounting standards.
xi. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.
xii. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.
xiii. It is either only issued with the approval of the owners of the issuing bank, given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.
xiv. It is clearly and separately disclosed on the bank's balance sheet.

2.4 Additional Tier 1 capital

22. In accordance with Articles 3.2 of the Capital Adequacy Regulation, AT1 capital consists of the sum of the following elements:

i. Instruments issued by a bank which are eligible for inclusion in AT1 and are not included in CET1 (e.g. perpetual equity instruments, not included in CET1);
ii. Stock surplus, or share premium, resulting from the issue of instruments included in AT1;
iii. Instruments issued by consolidated subsidiaries of the bank and held by third parties which are eligible for inclusion in AT1 and are not included in CET1;
iv. Regulatory adjustments applied in the calculation of AT1.

23. The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory deductions applied in the calculation of AT1 capital are addressed in separate sections of this document.

Instruments issued by the bank that meet the Additional Tier 1 criteria

24. The following is the minimum set of criteria for an instrument issued by the bank to meet or exceed in order for it to be included in Additional Tier 1 capital:

i. Issued and paid-in
ii. Subordinated to depositors, general creditors and subordinated debt of the bank
iii. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors
iv. Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem
v. May be callable at the initiative of the issuer only after a minimum of five years:
    a. To exercise a call option a bank must receive prior CBUAE approval; and
    b. A bank must not do anything which creates an expectation that the call will be exercised; and
    c. Banks must not exercise a call unless:
        1) They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
        2) The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.
vi. Any repayment of principal (e.g. through repurchase or redemption) must be with prior CBUAE approval and banks should not assume or create market expectations that CBUAE approval will be given.
vii. Dividend/coupon discretion:
    a. the CBUAE and the bank must have full discretion at all times to cancel distributions/payments
    b. cancellation of discretionary payments must not be an event of default
    c. banks must have full access to cancelled payments to meet obligations as they fall due
    d. Cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.
viii. Dividends/coupons must be paid out of distributable items
ix. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization's credit standing.
x. The instrument cannot contribute to liabilities exceeding assets in the required balance sheet test to determine insolvency.
xi. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either
    a. conversion to common shares at an objective pre-specified trigger point or
    b. a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

1. Reduce the claim of the instrument in liquidation;
2. Reduce the amount re-paid when a call is exercised; and
3. Partially or fully reduce coupon/dividend payments on the instrument.

xii. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

xiii. The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

xiv. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in AT1 capital (*This is only applicable for Islamic banks .Refer to the Capital Issuance Standard).*

xv. In addition to the criteria outlined above, the instrument must meet criteria for minimum requirements to ensure loss absorbency at the point of non-viability.

Share premium resulting from the issue of instruments included in Additional Tier 1 capital;

25. Share premium that is not eligible for inclusion in CET1, will only be permitted to be included in AT1 capital if the shares giving rise to the stock surplus are permitted to be included in AT1 capital.

2.5 Tier 2 capital

26. Tier 2 capital consists of the sum of the following elements:

i. Banks using the standardized approach for credit risk: general provision or general loan loss reserves, up to maximum of 1.25% of credit RWA;
ii. Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital, not included in Tier 1 capital;
iii. Share premium resulting from the issue of instruments included in tier 2 capital;
iv. Instruments which are eligible for inclusion of Tier 2 (e.g. subordinated loan)
v. Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital, not included in Tier 1 capital;
vi. Regulatory adjustments applied in the calculation of Tier 2.

27. The treatment of instruments issued out of consolidated subsidiaries of the bank and the regulatory deductions applied in the calculation of Tier 2 capital are addressed in separate sections of this document.

Instruments issued by the bank that meet the Tier 2 criteria

28. The objective of Tier 2 capital is to provide loss absorption on a gone-concern basis. Based on this objective, below are the minimum set of criteria for an instrument to meet or exceed in order for it to be included in Tier 2 capital.

Criteria for inclusion in Tier 2 Capital

i. Issued and paid-in
ii. Subordinated to depositors and general creditors of the bank
iii. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors
iv. Maturity:
    a. minimum original maturity of at least five years
    b. recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis
    c. there are no step-ups or other incentives to redeem
v. May be callable at the initiative of the issuer only after a minimum of five years:
    a. To exercise a call option a bank must receive prior CBUAE approval;
    b. A bank must not do anything that creates an expectation that the call will be exercised; and
    c. Banks must not exercise a call unless:
        1. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
        2. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.
vi. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
vii. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organization’s credit standing.
viii. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital (*This is only applicable for Islamic banks .Refer to the Capital Issuance Standard).*

29. In addition to the criteria outlined above, the instrument must meet the minimum requirements to ensure loss absorbency at the point of non-viability.

Share premium resulting from the issue of instruments included in Tier 2 capital

30. Share premium that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital.

General provisions/General loan-loss reserves:

General provisions or general reserve for loan losses will be limited to a maximum of 1.25 percentage points of credit risk weighted risk assets calculated under the standardised approach.

Article (3) Capital component of Capital Adequacy Regulation

31. If a bank has complied with the minimum CET1 and Tier 1 capital ratios, the excess AT1 capital can be counted to meet the total capital ratio, also referred to as Capital Adequacy Ratio (CAR).

32. Profit-sharing investment accounts must not be classified as part of an Islamic bank's regulatory capital as referred to in Article 2 of Capital Adequacy Regulation.

33. Investment risk reserves and a portion of the Profit Equalization Reserve (PER), if any, belong to the equity of investment account holders, and thus must not be used in the calculation of an Islamic bank's regulatory capital. As the purpose of a PER is to smooth the profit pay-outs and not to cover losses, any portion of a PER that is part of the Islamic bank's reserves must not be treated as regulatory capital as referred to in Article 2 of Capital Adequacy Regulations.

2.6 Additional criteria for AT1 and Tier 2 instruments: Minimum requirements to ensure loss absorbency at the point of non-viability.

34. In order for an instrument issued by a bank to be included in AT1 or Tier 2 capital, it must also meet or exceed the minimum requirements defined in Capital Issuance standards. These requirements are in addition to the criteria for AT1 and Tier 2 instruments stated above.

2.7 Minority interest (i.e. non-controlling interest) and other capital issued out of consolidated

Common shares issued by consolidated subsidiaries (***that is within the scope of regulatory consolidation)***

35. Minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in CET1 only if:

i. The instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and
ii. The subsidiary that issued the instrument is itself a bank.

36. The amount of capital meeting the above criteria that will be recognized in consolidated CET1 is calculated as follows

Total minority interest meeting the two criteria above minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders.

i. Surplus CET1 of the subsidiary is calculated as the CET1(after the application of regulatory deductions) of the subsidiary minus the lower of:
    a. the minimum CET1 requirement of the subsidiary plus the capital conservation buffer (i.e. 9.5% of risk weighted assets) and
    b. the portion of the parent's consolidated minimum CET1 requirement plus the capital conservation buffer (i.e. 9.5% of consolidated risk weighted assets) that relates to the subsidiary.
ii. The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.

Tier 1 qualifying capital issued by consolidated subsidiaries (that is within the scope of regulatory consolidation)

37. Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under paragraph 36) may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank meet all of the criteria for classification as Tier 1 capital.

38. The amount of this capital that will be recognized in Tier 1 will be calculated as follows:

Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third party investors.

i. Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary (after the application of regulatory deductions) minus the lower of:
    a. the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (i.e. 11% of risk weighted assets) and
    b. the portion of the parent's consolidated minimum Tier 1 requirement plus the capital conservation buffer (i.e. 11% of consolidated risk weighted assets) that relates to the subsidiary.
ii. The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third party investors.

The amount of this Tier 1 capital that will be recognized in Additional Tier 1 will exclude amounts recognized in CET1 under paragraph 36 .

Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries (that is within the scope of regulatory consolidation)

39. Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors (including amounts under paragraph 36 and 38) may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital

40. The amount of this capital that will be recognized in consolidated Total Capital will be calculated as follows:

Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.

i. Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary (after the application of regulatory deductions) minus the lower of:
    a. the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (i.e. 13% of risk weighted assets) and
    b. the portion of the parent's consolidated minimum Total Capital requirement plus the capital conservation buffer (i.e.13% of consolidated risk weighted assets) that relates to the subsidiary.
ii. The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in CET1 under paragraph 36 and amounts recognized in AT1 under paragraph 38 above.

41. An illustrative example for calculation of minority interest and other capital issued out of consolidated subsidiaries that is held by the third parties is furnished as annex 4.

Other Instructions relating to the calculation of the amount of minority interest

42. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (i.e. the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group).However, the bank may elect to give no recognition (in consolidated capital of the group) to the capital issued by the subsidiary to third parties.

43. Where capital has been issued to third parties out of an SPV, none of this capital can be included in CET 1. However, such capital can be included in consolidated AT 1 or Tier 2 capital and treated as if the bank itself had issued the capital directly to the third-parties only if:

i. it meets all the relevant entry criteria; and

ii. the only asset of the SPV is its investment in the capital of the bank in a form that meets or exceeds all the relevant entry criteria (as required by criterion xiv for Additional Tier 1 and criterion ix for Tier 2 capital)

In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the bank, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may be included in the bank's consolidated AT 1 or Tier 2 in accordance with the treatment outlined in paragraphs 38 and 40.

3. Regulatory adjustments

44. This section sets out the regulatory adjustments to be applied to regulatory capital. In all cases, these adjustments are applied in the calculation of CET 1.

3.1 Goodwill and other intangibles

45. Goodwill and all other intangibles must be deducted in the calculation of CET1 (this deduction includes mortgage servicing rights), including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation. The full amount is to be deducted net of any associated deferred tax liability, which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards.

46. Banks are required to use the IFRS definition of intangible assets to determine which assets are classified as intangible and required to be deducted.

3.2 Deferred tax assets

47. Deferred tax assets (DTAs) that rely on future profitability of the bank to be realized are to be deducted in the calculation of CET1. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and the relevant taxation authority permits offsetting.

48. The treatment for DTA are classified as:

i. Where these DTAs relate to temporary differences (e.g. allowance for credit losses) the amount to be deducted is set out in the "threshold deductions".
ii. All other DTAs, e.g. those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of DTL as described above.

49. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment and DTAs that are to be deducted in full.

50. An over-instalment of tax or, in some jurisdictions, current year tax losses carried back to prior years may give rise to a claim or receivable from the government or local tax authority. Such amounts are typically classified as current tax assets for accounting purposes. The recovery of such a claim or receivable would not rely on the future profitability of the bank and would be assigned the relevant sovereign risk weighting.

3.3 Cash flow hedge reserve

51. The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of CET1. This means that positive amounts should be deducted and negative amounts should be added back.

This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized for prudential purposes. It removes the element that gives rise to artificial volatility in common equity, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow).

3.4 Gain on sale related to securitization transactions

52. Derecognize in the calculation of CET1 any increase in equity capital resulting from a securitization transaction, such as that associated with expected Future Margin Income (FMI) resulting in a gain-on-sale.

3.5 Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities

53. Derecognize in the calculation of CET1, all unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

3.6 Defined benefit pension fund assets and liabilities

54. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of CET1 (i.e. CET1 cannot be increased through derecognizing these liabilities).

55. For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of CET1 net of any associated deferred tax liability, which would be extinguished if the asset should become impaired or derecognized under the relevant accounting standards.

56. Assets in the fund to which the bank has unrestricted and unfettered access can, with CBUAE approval, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank.

57. This treatment addresses the concern that assets arising from pension funds may not be capable of being withdrawn and used for the protection of depositors and other creditors of a bank. The concern is that their only value stems from a reduction in future payments into the fund. The treatment allows banks

to reduce the deduction of the asset if they can address these concerns and show that the assets can be easily and promptly withdrawn from the fund.

3.7 Investments in own shares (treasury stock)

58. All of a bank's investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of CET1 (unless already derecognized under the relevant accounting standards).

59. In addition, any own stock, which the bank could be contractually obliged to purchase, should be deducted in the calculation of CET1. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:

i. Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.
ii. Banks should look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short position in own shares resulting from short positions in the same underlying index. In such cases, the short positions may involve counterparty risk (which will be subject to the relevant counterparty credit risk charge).

60. Following the same approach outlined above, banks must deduct investments in their own AT1 in the calculation of their AT1 capital and must deduct investments in their own Tier 2 in the calculation of their Tier 2 capital.

3.8 Reciprocal cross holdings in the capital of banking, financial and insurance entities

61. Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full from CET.

3.9 Investments in the capital of banking, securities, financial and insurance entities where the bank owns up to 10% of the issued common share capital of the entity

62. The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity. In addition

i. Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.

ii. Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).
iii. Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
iv. If the capital instrument of the entity in which the bank has invested does not meet the criteria for CET1, AT1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.
v. Banks may, with prior CBUAE approval, exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

63. If the total of all holdings listed above in aggregate exceed 10% of the bank's common equity (after applying all other regulatory deductions in full, apart from the deductions outlined in this section (paragraph 62 to 70)) then the amount above 10% is required to be deducted from CET 1.

64. Amounts below the threshold that are not deducted are to be risk weighted as follows:
i. Amounts below the threshold that are in the banking book are to be risk weighted as per the credit risk(i.e. investments that are not listed and not marked to market will be risk weighted at 150% and investments that are listed will be risk weighted at 100%).
ii. Amounts below the threshold that are in the trading book are to be risk weighted as per the market risk rules.

3.10 Significant investments in the capital of banking, securities, financial and insurance entities that are outside the scope of regulatory consolidation

65. The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the bank. In addition
i. Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.
ii. Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year)

iii. Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.
iv. If the capital instrument of the entity in which the bank has invested does not meet the criteria for CET1, AT1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.
v. Banks may, with prior CBUAE approval, exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

66. All investments included above that are not common shares must be fully deducted from CET 1.

67. Investments included above that are common shares will be subject to the “Threshold deductions” treatment described in the section 4.

4. Threshold deductions

68. Instead of a full deduction, the following items may each receive limited recognition when calculating CET1, with recognition capped at 10% of the bank's common equity (after applying all other regulatory deductions in full, apart from the deductions outlined in this section (paragraph 68 to 70)):

i. Significant investments in the common shares of unconsolidated financial institutions (banking, securities and other financial entities) and insurance entities as referred to in Section 3.10 (paragraph 67). Any amount exceeding this 10% threshold is deducted from CET1 capital;
ii. DTAs that rely on future profitability and arise from temporary differences. Any amount exceeding this 10% threshold is deducted from CET1 capital.

The amount below the 10% threshold of the above two items are aggregated and must not exceed 15% of the Common Equity Tier 1 capital (after application of all other regulatory adjustments and the amount of significant investments in the common shares of unconsolidated financial institutions and deferred tax assets in full).The calculation for threshold deduction is explained with an example in Annex 5.

69. The amount of the two items (outlined in paragraph 68) that are not deducted in the calculation of CET1 will be risk weighted at 250%.

<u>Former deductions from capital</u>

70. The following items, which under Basel II were deducted 50% from Tier 1 and 50% from Tier 2 (or had the option of being deducted or risk weighted), will receive a 952% risk weight:

i. Certain securitization exposures;
ii. Non-payment/delivery on non-DvP and non-PvP transactions; and
iii. Significant investments in commercial entities

5. Significant investments in commercial entities

71. Significant investments in commercial entities are defined as investments in commercial entities that are, on an individual basis, greater than or equal to 10% of the bank's CET1 capital (after the application of all regulatory deductions). The amount in excess of the threshold of 10% (for each individual investment) will be risk weighted at 952%.

72. If the aggregate of the amount of such significant investments that is not in excess of the threshold (i.e. amount of such investments not risk weighted at 952%) is greater than 25% of the bank's CET1 capital (after the application of all regulatory deductions), the amount in excess of 25% must also be risk weighted at 952%. The amount in excess will be allocated to individual investments in a proportionate basis (refer to Annex 3 for an illustrative example).

73. Amounts below the thresholds that are not risk weighted at 952% are to be risk weighted as follows:

i. Amounts below the thresholds that are in the banking book are to be risk weighted as per the credit risk rules (i.e. investments that are not listed will be risk weighted at 150% and investments that are listed will be risk weighted at 100%).

ii. Amounts below the thresholds that are in the trading book are to be risk weighted as per the market risk rules.

6. Transitional Arrangements

74. Minority investment in banking, financial and insurance entities that are not deducted as per section 3.9 will be risk weighted at 100% if the entity is listed and 150% if the entity is unlisted. Application of risk weight for unlisted entities will have transitional arrangement as follows:

Year	End of 2017	1st Jan 2018	1st Jan 2019	1st Jan 2020 onwards
Risk weights	100%	115%	130%	150%

75. Equity investment in commercial entities that are below the thresholds as per section 5 will be risk weighted at 100% if the entity is listed and 150% if the entity is unlisted. Application of risk weight for unlisted companies will have transitional arrangement as follows:

Year	End of 2017	1st Jan 2018	1st Jan 2019	1st Jan 2020 onwards
Risk weights	100%	115%	130%	150%