LIQUIDITY REVIEW

Assessment of the Implementation of the Liquidity Coverage Ratio

Dubai Financial Services Authority

EXECUTIVE SUMMARY

Liquidity is a key risk for any institution engaged in financial intermediation. The DFSA imposes a series of quantitative measures on specific categories of Authorised Firms ('Firms') to mitigate the risk of those Firms being unable to meet their liabilities as they fall due, in particular, Accepting Deposits (Prudential Category 1) and Managing Unrestricted Profit-Sharing Investment Account (Prudential Category 5). These measures include minimum ratios which are one aspect of liquidity risk management, and which must be complemented by Firms demonstrating adequate internal systems, controls and effective governance arrangements, and risk-based supervisory work undertaken by DFSA supervisors.

Over the last few months, the DFSA conducted an in-depth thematic review of the liquidity risk of Category 1 Firms (the 'Review') to assess the adequacy of their implementation of the Liquidity Coverage Ratio ('LCR') requirements set out in the PIB Module of the DFSA Rulebook.

Firms were first asked to complete a comprehensive quantitative template which required disclosure of certain of their proprietary data not readily available to the DFSA; and to fill a qualitative questionnaire covering governance and risk management. After analysing Firms' responses, the DFSA then selected a sample of Firms for in-person meetings to discuss their specific responses and overall liquidity risk management framework.

The key findings of the Review are:

- Firms' overall DIFC portfolios of liquid assets are of good quality.
- Firms prioritised the holding of High-Quality Liquid Assets ('HQLA') Level 1 assets over potentially higher yielding but lower quality Level 2 assets.
- Certain Firms had erroneously included ineligible securities in the pool of liquid assets forming part of the HQLA calculation. These ineligible securities should be excluded from the HQLA calculation or reclassified to a lower tier.
- The DFSA observed certain issues around the valuation of the liquid assets, specifically concerning the methodology used to value the assets (not reported at fair value) and the frequency of valuations.
- Firms maintained control of their liquidity locally and demonstrated an unfettered ability to monetise the assets under their control to meet their liabilities as they fall due.
- The DFSA identified instances where certain Firms had not implemented, or had misinterpreted, certain of the operational requirements concerning management of the pool of liquid assets, such as periodical monetisation of the portfolio and the price decline test.
- The DFSA also identified some examples of best practices around the automation of LCR computation, diversification of securities holdings in portfolios, and the use of a comprehensive methodology to assess historical volatility of all HQLA.

The DFSA expects Firms that are subject to the LCR requirement to review this report and the findings, assess their relevance to the Firm, and implement appropriate actions to remedy identified deficiencies.

BACKGROUND

The LCR is one of the Basel Committee on Banking Supervision ('BCBS') key reforms to develop a more resilient banking sector following the 2007-2008 global financial crisis ('GFC'). The objective of the LCR is to promote the short-term resilience of the liquidity risk profile of banks. It is achieved by ensuring that banks have an adequate stock of unencumbered HQLA that can be converted easily and immediately into cash in private markets to meet their liquidity needs for the next 30 days under a severe liquidity stress scenario.

The LCR standard defines which assets are eligible for inclusion as HQLA through eligibility criteria as well as operational requirements. The LCR also prescribes the outflow and inflow parameters to apply to each broad category of balance sheet items and off-balance commitments. Its calibration reflects the conditions experienced during the GFC. Outside of a stress period, Firms must maintain a regulatory ratio of at least 100% on an ongoing basis, i.e. their holding of HQLA must at least cover the net 30-day outflows under the modelled stress scenario.

The liquidity standards developed by the BCBS (LCR and Net Stable Funding Ratio) apply to internationally active banks on a consolidated basis and in a common reporting currency. The DFSA requirements on liquidity are outlined under the Prudential – Investment, Insurance Intermediation and Banking Module ('PIB'), Section 9 - Liquidity Risk. These are broadly aligned with BCBS requirements.

Nonetheless, the DFSA elected to apply the LCR standard to Category 1 and Category 5 Firms[1], including branches of foreign banks. The rationale for subjecting branches to a stand-alone LCR requirement was driven by the unique characteristics of liquidity risk in the DIFC, i.e. absence of a lender of last resort and no access to retail deposits, a traditionally more stable source of funding than wholesale funding.

The BCBS has now shifted its work programme from policy response to the evaluation of the effectiveness and impact of its post GFC reforms. The BCBS also runs a Regulatory Consistency Assessment Programme to ensure a full, timely and consistent implementation of the Basel III framework by its member jurisdictions. While the DFSA is not a member of the BCBS, its mission is to benchmark itself to the best international practices.

A robust implementation of the LCR provisions is necessary to ensure the standard meets its policy objectives as well as to ensure a level playing field for Firms operating in the DIFC. Hence, the Banking Supervision team conducted an in-depth review of the liquidity risk of Category 1 Firms to assess the adequacy of their implementation of the LCR.

1. Category 1 Firms referred to in this report are those authorised to carry on the Financial Service of Accepting Deposits. Category 5 Firms are those authorised to carry on the Financial Service of Managing Unrestricted Profit-Sharing Investment Account. Certain Firms that are established as branches, and which fund themselves solely or almost entirely on a back-to-back basis with their respective head office, were granted an exemption from complying with the PIB liquidity requirements due to the absence of any material liquidity risk. (i.e. Global Liquidity Concession).

OBJECTIVES

The objectives of the Review were to document the range of Firms' practices around the LCR, identify deviations from the PIB Rules and interpretation issues, and, where needed, propose supervisory or policy responses to bring applicable Firms into regulatory compliance, keeping in mind the purposive intention of the applicable PIB Rules.

More specifically, the Review assessed Firms':

- compliance with the eligibility criteria and operational requirements set out in PIB;
- composition of the HQLA portfolio;
- effective control over the HQLA portfolio;
- accounting treatment and classification of HQLAs;
- evidence of periodical monetisation of the HQLA portfolio;
- potential for "window dressing";
- approach to determining fair value of the HQLAs;
- calculation of outflows and inflows; and
- overall risk management framework and governance arrangements.

SCOPE AND METHODOLOGY

The Review covered 22 Firms in the DIFC that are subject to the LCR requirements in PIB. Of the 22 Firms surveyed, 15 Firms can be described as holding "simple" portfolios, whereas the remaining 7 Firms have more complex portfolios in terms of diversity of holdings (issuers and issuer types, countries and currencies of issuance, inclusion of Level 2 securities, securities eligible through national discretion provisions, etc.) and types of transactions (active repo market participants).

The Review was undertaken in three phases:

PHASE ONE

Questionnaire and Desk-Based Review

During this phase, Firms were asked to complete a questionnaire which included a detailed breakdown of their HQLA portfolio, transactions, and intra quarter LCR data points with their proprietary data. The questionnaire also enquired into Firms' risk management practices and governance arrangements.

The DFSA then analysed the questionnaire responses, including cross checking with internal and external data sources. The Review team also reached out to several Firms to clarify or validate their responses.

PHASE TWO

On-site Visits

This phase involved on-site visits to selected Firms to discuss their questionnaire responses and enhance the Review team's understanding of the particular Firm's management, systems, controls, and governance of the LCR and other liquidity risk aspects. The selection criteria focused on Firms with complex portfolios, transactions, or governance arrangements.

PHASE THREE

Report and Action Plan

During this phase, the Review team consolidated all the observations, findings, data, and actions in this public report. Firm specific observations and findings will be addressed on a bilateral basis with remedial actions and timelines communicated to each Firm directly (as applicable).

OBSERVATIONS AND FINDINGS

This section sets out the DFSA's general observations, key findings (including deviations from PIB regulatory requirements), and actions required for best practices and to address identified issues.

General Observations

The aggregate portfolio of Firms operating in the DIFC is of high quality with close to 80% of the holdings in the form of highly rated Level 1 assets. Firms opted to limit their holdings of Level 2 securities below the prescribed composition limits, effectively preferring quality over additional yield. The securities are mostly denominated in USD corresponding to the functional currency of the DIFC and in line with outflows of the Firms.

Group 1 Firms - Simple Portfolios

Firms in the first group maintain their HQLA portfolio mostly in a few issuances of US Treasuries denominated in US dollars, either zero coupon bills or medium-term notes. The securities are held outright (i.e. not through reverse repo), with a third-party custodian. Control over the portfolio lies with the DIFC branch where the authority to transact is assigned to a local treasurer or other Authorised Individual.

Group 2 Firms - Complex Portfolios

Firms in the second group, i.e. those with more complex portfolios, have large and highly diversified holdings of securities, including US Treasuries, Gulf Cooperation Council Countries and Asian sovereign bonds and Sukuks, Multilateral Development Banks, Public Sector Entities, corporates, and covered bonds. Most of the Firms actively manage the LCR's composition to benefit from higher yielding securities eligible for Level 2A and 2B, although no Firm reported holding equity shares as Level 2B. Firms' portfolios are mostly denominated in USD. Certain of these Firms make an active use of repos and reverse repos to manage their LCR levels, optimise the yield on their portfolio, or reallocate excess liquidity to other parts of their group. No breaches or near breaches were noted for Firms in this group. These Firms set operating buffers above the regulatory requirements minimum and managed their LCR more dynamically.

Key Findings and Actions Required

The Review revealed the following findings, including deviations from the PIB requirements. All Firms subject to the LCR requirements are expected to review the findings and the best practices in this report, assess the relevance to their firm, and implement appropriate actions where required.

The DSFA regulatory approach is risk-based and aims to avoid unnecessary regulatory burden. Accordingly, the DFSA continues to be open to engage with all Firms in order to consider specific cases which may require alternate treatment, or to discuss any challenges to implement the PIB regulatory requirements, including the actions required in this report. All Firms are encouraged to approach the DFSA for further discussions where necessary.

1. Periodic monetisation of the HQLA portfolio

Under PIB A.9.2.3(b), Firms are required to periodically (at least annually) liquidate a representative portion of the assets in the stock of HQLA to test their access to the market, the effectiveness of their processes for liquidation, the availability of the assets, and to minimise the risk of negative signalling during a period of actual stress.

While we observed most Firms either sold or repoed securities expressly for testing purposes or as business as usual, several Firms did not monetise any security through sale or repo in the last year.

Certain other Firms tended to transact with their respective head office or other counterparties that are members of the same financial group.

We also identified instances where certain Firms were reluctant to sell securities for the sole purpose of testing given the accounting, cost, and taxation implications. This is, in part, due to a misinterpretation of the PIB Rules where Firms could achieve the same objective with a repo transaction. We note that the PIB Rules require Firms to “liquidate” their HQLAs whereas BCBS LCR standard use “monetise” and adds “through repo or outright sale” and further clarifies the treatment with a FAQ.

The DFSA acknowledges this misalignment and will clarify the applicable PIB Rules requirements, including the purposive intention of those Rules.

Action Required:

Firms are required to periodically liquidate (at least annually) a portion of the assets in their HQLA portfolio, ideally with external market participants. This can be achieved through either repo or outright sale of the relevant securities.

2. Use of Static Values in Calculating the LCR

Firms must calculate and meet an LCR of 100% on an ongoing basis as mandated in PIB Rules 9.3.3, 9.3.4, and A9.2.1.

Almost all Firms contend that they calculate their LCR on a daily basis, however, for several Firms the ratio numerator i.e. HQLA is refreshed on different frequencies, some monthly or even quarterly.

The LCR has three components: HQLA, outflows, and inflows. Relying on static values for a component of the ratio distorts the outcome and does not allow for an “ongoing” accurate calculation and monitoring of compliance with the stipulated minimum LCR levels. For certain Firms, it may be reasonable under a risk-based approach to have some static values for a limited period (e.g. infrequent and highly predictable outflows); however, on the whole, we would expect Firms to refresh all data points at a daily frequency.

A few Firms that indicated they are dependent on data provided periodically by their head office will need to engage with their head office to increase the frequency of access to the data.

Action Required:

Firms must calculate their LCR using updated and non-static data.

3. Eligibility Criteria of HQLA

Eligibility of securities for inclusion in the HQLA portfolio for the purpose of LCR are restricted to those that meet the fundamental criteria outlined specifically for Level 1, Level 2 (including Level 2A and Level 2B) (PIB A9.2.6 to A9.2.8). Certain of these criteria are straightforward (e.g. minimum credit rating) whereas other criteria are based on expert judgement and more open to interpretation (e.g. definition of "deep" market).

Firms with simple portfolios only hold "vanilla" securities (US Treasuries, recognised Multilateral Development Banks' bonds) hence no issues were observed. However, those Firms with more complex portfolios included certain securities that do not meet the specified eligibility criteria and, accordingly, should not have been included as HQLA. A discussion on the specifics of each qualifying HQLA security is beyond the scope of this report and overly technical. That being said, the DFSA has or will communicate directly with the concerned Firms where issues around eligibility were identified. During the Review, Firms were also given the opportunity to present their rationale and justifications for inclusion of securities considered outside the permitted types of HQLA.
In particular, the Review team observed inclusion of securities:

- not meeting the credit rating requirements or being misclassified based on the credit ratings;
- representing obligations of Financial Institutions irrespective of the ultimate shareholders;
- exhibiting excessive volatility; and
- meeting the qualifying criteria but with lack of depth of market (e.g. wide bid-ask spreads, minimal volume of trading).

Despite the above observations, given impacted Firms' large HQLA surpluses, it is our expectation that the exclusion or reclassification of certain securities should not cause those Firms to breach or come close to breaching their applicable LCR minimum requirements or applicable internal limits.

Action Required:

Firms must implement appropriate governance and control arrangements to ensure that only eligible securities are included in the HQLA portfolio at the outset and on a continuing basis.

4. Testing Volatility of Securities

Keeping with eligibility, inclusion of a security in the HQLA portfolio is contingent on that security having a proven track record as a reliable source of liquidity in the markets even during stressed market conditions. To this end, Level 2 securities are subject to a price filter test whereby the security must not have had any price decline or increase of haircut of more than 10%, 20%, or 40% (depending on the type of asset) over a 30-day period during a relevant period of significant liquidity stress (PIB A9.2.7(2)(a)(iii) and (b)(v),A9.2.8(2)(a)(iv), (b)(iv), and (c)(vi)).

We observed that several Firms with complex portfolios are not applying the price filter test for various reasons (e.g. reliance on Bloomberg HQLA flag), while other Firms implemented different methodologies not in line with PIB Rules requirements or conducted testing only on the Level 2B requirement. Certain other Firms are not applying the price filter test due to following the approach adopted by their head office. We would like to emphasise that Firms, including branches, must comply with the PIB Rules requirements. The need to report HQLAs to their head office based on the parent entity criteria does not justify divergence from DFSA Rules which are not conditioned by or subject to head office requirements.

The DFSA recognises that implementing this price filter test will give rise to certain challenges, such as setting the parameters and methodology which may result in varying interpretations. The DFSA will work with impacted Firms to ensure the purposive intention of the PIB Rules are met while taking into account Firms' divergent nature and complexity.

Further, Level 1 securities are not subject to a quantified requirement, rather the PIB Rule simply mandates that they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions[2]. However, data collected demonstrated that several securities that would otherwise be eligible as Level 1, including from Sovereigns, have also experienced episodes of extreme volatility.

As a matter of better practice, we observed that certain Firms have fully integrated their methodology within their risk management processes (i.e. rather than a compliance exercise) where the results are used to estimate realisable values/haircuts of HQLA under a stress scenario. These Firms also extend the calculation to Level 1 securities and base this on a rolling 30-day period to avoid selection biases.

Action Required:

Firms must assess the admissibility of a security against the eligibility criteria for each Tier (i.e. Level 1, 2A, and 2B) as set out in the PIB Rules prior to including that security as HQLA and not simply rely on a head office/parent or third-party supplier approaches/classifications.

2. PIB Rule A9.2.6(2)

5. Valuation of HQLA

Securities included in the HQLA portfolio for the purpose of calculating the LCR must be valued and reported at market value, i.e. marked-to market (PIB A9.2.6 (1), A9.2.7 (1), and A9.2.8 (1), to ensure their valuation reflects their liquidity raising potential. In order to qualify as HQLA, a security must be readily accessible, with no legal, accounting or practical impediments to the ability to monetise it in a timely manner.

Certain Firms reported their HQLA measured at amortised cost, others reported the nominal value, while others reported values that are neither the fair value nor the carrying amount. In all cases, these measures do not correspond to fair value as required.

Accounting/financial reporting principals, including the International Financial Reporting Standards ('IFRS'), allow various classifications and measurements of financial assets, including assets eligible as HQLA. From an accounting perspective, Firms might report HQLAs at fair value or at amortised cost in their financial statements i.e. balance sheet, however, Firms must report HQLA exclusively at market value for their liquidity returns.

While this issue continues to be debated globally and has been re-surfaced following the 2023 banking turmoil, the DFSA is of the view that as a prudent risk management measure, it is preferable to align the valuation of HQLA in the financial statements to that of liquidity reporting, including for LCR calculations.

Action Required:

Firms must implement appropriate controls to ensure that securities are valued and reported at market value, irrespective of the treatment applied in the Firm's home jurisdiction for accounting classification.

6. Currency Mismatches

Firms carrying on financial services business in multiple currencies must calculate their LCR on an ongoing basis and separately for each significant currency (PIB A9.2.1) to ensure they are able to meet their liquidity needs in each currency in which they have a significant exposure[3]. PIB A9.2.12 adds further colour by stating that the currencies of the stock of HQLA of a Firm must be similar in composition to its liquidity needs (i.e. outflows) by currency.

Certain Firms with significant foreign currency funding do not maintain any, or only maintain minimal, HQLA in the corresponding currency, claiming that they can source all required local currency from their head office market. In some of the cases, the foreign denominated funding is due to their respective head office, but some third-party funding is also sourced.

Action Required:

Firms with significant foreign currency funding must maintain a minimum LCR of 100% for each significant currency.

3. A currency is considered significant if the aggregate liabilities denominated in that currency amount to 5% or more of the Firm's total liabilities. See guidance to PIB Rule A9.2.1.

7. Triggers and Escalation

Although most Firms have comprehensive documented liquidity policies, a few lack clear risk appetite statements. These statements should include a target LCR, or operational range applicable in normal conditions, triggers or early warnings indicators, and have documented and clear escalation procedures to deal with a breach of these liquidity levels, including invoking the Contingency Funding or Recovery Plan. We observed that some intra-quarter internal liquidity breaches did not trigger the expected responses, and in some cases roles and responsibilities were not clearly understood.

Action Required:

Firms must have a documented liquidity risk appetite statement. This statement should include triggers or early warning indicators and have documented policies and clear escalation procedures to deal with a breach of these liquidity levels, including invoking the Contingency Funding Plan or Recovery Plan.

8. Reporting Errors and Automation

Finally, the Review also revealed several reporting errors with liquidity-related schedules submitted to the DFSA via EPRS. Although these are Firm specific, and have been addressed directly with the relevant Firm, the DFSA would like to remind Firms to ensure that the data they provide through EPRS is accurate and timely, and as such, should be subject to appropriate controls and governance arrangements.

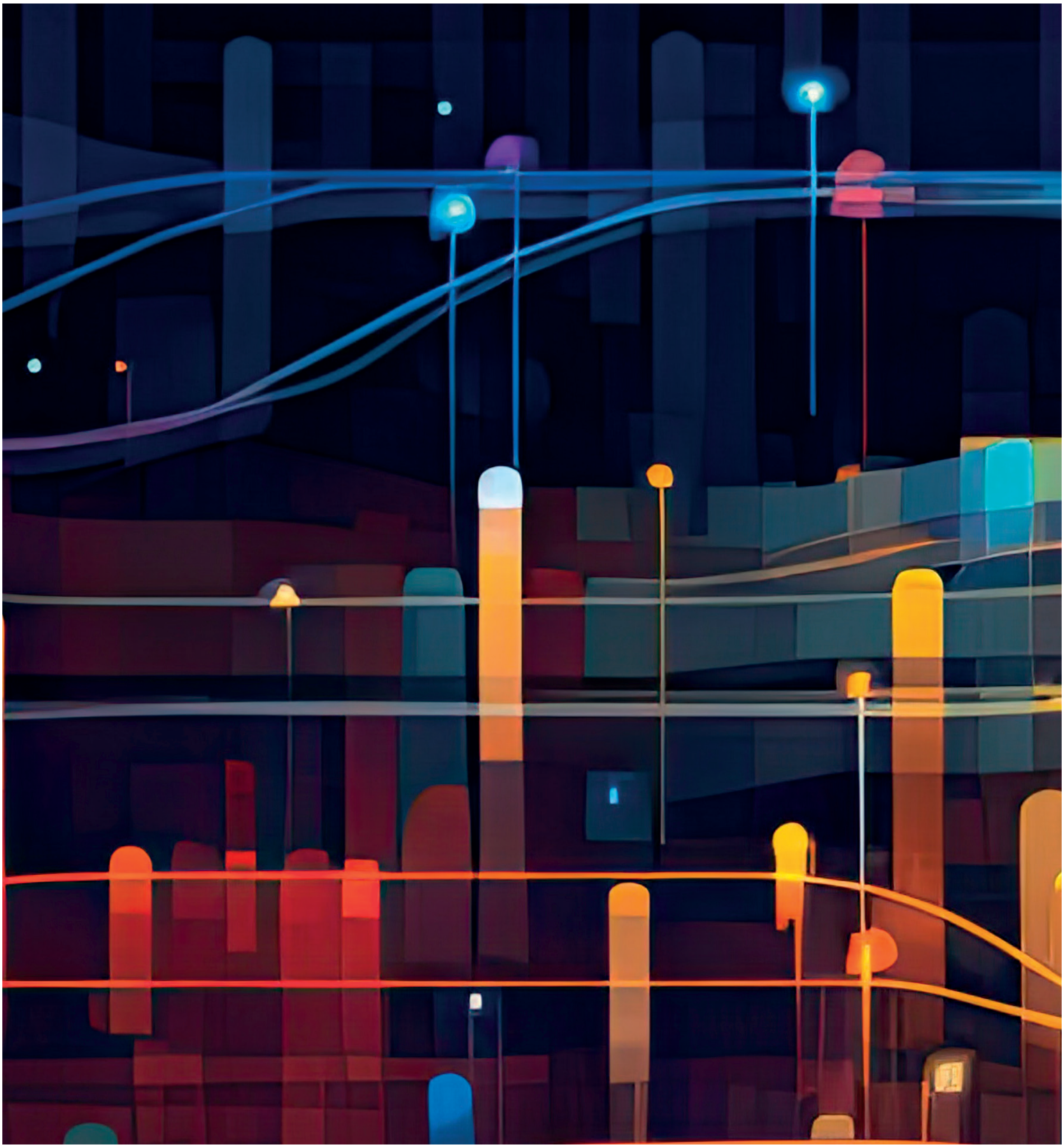
Similarly, we also observed varying levels of automation with certain Firms still relying heavily on manual input while others have fully automated processes which assist in mitigating operational risks.

Action Required:

Firms must ensure the accuracy of regulatory reporting to the DFSA and strive to achieve a high degree of automation for liquidity returns to reduce the risk of human error.

FINAL COMMENTS

The DFSA would like to extend its thanks to staff at the Firms who participated in the Review by providing quality data and thorough responses to the questionnaire, follow-ups, and on-site visits. Both the surveyed Firms and the DFSA acknowledge and support the objectives of the LCR and recognise the importance of a robust implementation of the standard to mitigate liquidity risk and ensure a level playing field across firms operating in the DIFC.



Dubai Financial Services Authority

About the DFSA

The Dubai Financial Services Authority (DFSA) is the independent regulator of financial services conducted in and from the Dubai International Financial Centre (DIFC), a purpose-built financial free zone in Dubai. The DFSA's regulatory mandate covers asset management, banking and credit services, securities, collective investment funds, custody and trust services, commodities futures trading, Islamic finance, insurance, crowdfunding platforms, money services, an international equities exchange and an international commodities derivatives exchange.

In addition to regulating financial and ancillary services, the DFSA is responsible for administering Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) legislation that applies to regulated firms and Designated Non-Financial Businesses and Professions in the DIFC.

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