PROPOSED AMENDMENTS TO THE COUNTERPARTY CREDIT RISK & EXPOSURES TO CENTRAL COUNTERPARTIES AND MINOR CHANGE TO THE AUDITOR APPOINTMENT NOTIFICATION REQUIREMENTS

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Consultation Paper 2021/03
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Attachment 1: Proposed draft Banking Business Prudential (Counterparty Credit Risk) and Miscellaneous Amendments Rules 2022
PROPOSED COUNTERPARTY CREDIT RISK & EXPOSURES TO CENTRAL COUNTERPARTIES
AND
MINOR CHANGES TO THE AUDITOR APPOINTMENT NOTIFICATION REQUIREMENTS

Invitation to comment

The Qatar Financial Centre ("QFC") Regulatory Authority ("Regulatory Authority") seeks public comment on the proposed Banking Business Prudential (Counterparty Credit Risk) and Miscellaneous Amendments Rules 2022 ("the draft Rules") (see Attachment 1).

The prudential banking framework that applies to conventional QFC authorised banks ("QFC banks") is largely based on the international framework for banks developed by the Basel Committee on Banking Supervision ("BCBS"). As part of its ongoing work program to implement the BCBS framework, the Regulatory Authority is proposing to update its prudential banking framework to include new requirements related to the prudential treatment for bilateral transactions and centrally cleared transactions, as well as a counterparty credit risk management framework for centrally cleared exposures and for banks acting as a clearing member.

The Islamic Financial Services Board ("IFSB") has not finalised its work to update the counterparty credit risk capital requirement applicable to Islamic banks, therefore the Regulatory Authority is proposing to defer updating the counterparty credit risk framework in the Islamic Banking Business Prudential Rules 2015 until the IFSB standards are finalised and published.

In addition, the Regulatory Authority is proposing a minor change to the General Rules 2006 ("GENE") in respect of auditor appointment notification requirements.

The Regulatory Authority is seeking to assess the impact of these proposals on QFC banks and auditors.

These revisions support the Regulatory Authority’s commitment to the maintenance of high international regulatory standards for conventional and Islamic financial services and the continued development of the QFC as a leading financial and business centre in the Middle East.

Please submit your comments by 31 March 2022 on the Counterparty Credit Risk proposals and by 28 February 2022 for the GENE proposals and include contact details for the organisation represented, to:

Policy Department
QFC Regulatory Authority
PO Box 22989
Doha
Qatar

Or email to: consultationpapers@qfcra.com

These proposals are relevant to QFC banks and auditors.

In accordance with its statutory objectives, the Regulatory Authority may make all responses to formal consultation available to the public. Respondents who would like their submission, or part of their submission, to remain confidential should provide this information marked as confidential. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.
1 Introduction

1.1 In June 2021, the Regulatory Authority issued a consultation paper (CP 2021/01) and proposed draft Rules - Banking Business Prudential (Credit Risk and related Matters) Amendments Rules 2021 - to amend the Banking Business Prudential Rules 2014 (“BANK”) to include the latest BCBS standards and guidance on the standardised approach for credit risk, the standardised approach for equity investments in funds, and the large exposures framework. In these proposals, the Regulatory Authority is also clarifying the boundary of the allocation of assets between the trading and banking books included in the BCBS’ Fundamental Review of the Trading Book (“FRTB”). The Regulatory Authority did not include in its BANK amendment proposals the standardised approach to counterparty credit risk (“SA-CCR”).

1.2 Therefore, the Regulatory Authority is now proposing new prudential requirements for counterparty credit risk and exposures to central counterparties. It is foreseen that the newly proposed Rules will be merged into the larger amendment of BANK proposed in June 2021.

1.3 In developing the updated Counterparty Credit Risk (“CCR”) framework, the BCBS main objectives were to devise an approach that: (i) is suitable to be applied to a wide variety of derivatives transactions, (ii) is capable of being implemented simply and easily, (iii) addresses known deficiencies in the Basel II prudential approaches framework, (iv) minimises discretion used by national authorities and banks, and (v) improves the risk sensitivity of the capital framework without creating undue complexity.

1.4 In developing the draft Rules, the Regulatory Authority has considered the standardised approaches set out in the BCBS standards and some elements of the CCR frameworks implemented by the Australian Prudential Regulation Authority (“APRA”) and the United Kingdom Prudential Regulation Authority (“PRA”). Both the BCBS standardised approach and the APRA and PRA frameworks are considered appropriate benchmarks for the QFC as the standards and requirements provide flexibility in their application to smaller and less complex banks.

1.5 The Regulatory Authority is also proposing a minor change to the General Rules 2006 (“GENE”) in respect of auditor appointment notification requirements.

1.6 This Consultation Paper contains the following attachment:

**Attachment 1**: Proposed draft Banking Business Prudential (Counterparty Credit Risk) and Miscellaneous Amendments Rules 2022
2 Proposed amendments to calculate the capital charge for counterparty credit risk for bilateral transactions

2.1 The proposed CCR framework for bilateral transactions concerns exposures arising from OTC derivatives, exchange-traded derivatives, long settlement transactions and Securities Financing Transactions (“SFTs”).

2.2 CCR is the risk that a bank suffers a loss in the event that a counterparty to a transaction defaults before the final settlement of the transaction’s cash flows. It involves consideration of credit and market risks generated by changes in the creditworthiness of the counterparty and movements in underlying market risk factors.

2.3 The risk-based capital charges for CCR in the BCBS framework cover two important characteristics of CCR which are the risk of counterparty default and a credit valuation adjustment (“CVA”):

a Default Risk – concerns potential losses from counterparty default. Estimating the exposure amount is critical to calculate the capital requirements for CCR. The exposure amount for a particular netting set multiplied by the risk weight, using the Standardised Approach for Credit Risk, is the risk weight asset in the CCR default risk calculation. To calculate the CCR exposure amount, there are two non-modelled approaches: the credit risk mitigation approach in Basel II (“CRM”) and the newly developed Standardised Approach for CCR (“SA-CCR”). The SA-CCR is available for OTC derivatives, exchange-traded derivative transactions and long settlement transactions. However, only the CRM can be applied to SFTs.

b CVA Risk – concerns potential losses arising through a change in the mark-to-market value of a bank’s exposures to its derivative and SFTs counterparties.

2.4 The diagram below sets out the types of risk to consider for each type of transaction and the proposed exposure method and approach (indicated in the blue and green boxes) for certain CCR risks to calculate the capital charge for CCR bilateral transactions.

1 SFTs typically are transactions such as repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions where the value of the transactions depends on the market valuation of securities and the transactions are typically subject to margin agreements.
**Counterparty credit risk exposures arising from OTC derivative transactions, exchange-traded derivative transactions and long settlement transactions**

**Capital charge for default risk**

2.5 The Regulatory Authority carried out an extensive benchmarking exercise of jurisdictions such as Australia and the United Kingdom to identify how the SA-CCR has been implemented for small and less complex banks. Regulators from those countries recently conducted quantitative impact assessments of the impact of the SA-CCR on their respective regulated banks. Both regulators concluded that for banks where there was limited use of derivatives, the SA-CCR was complex, and unsuitable. Based on the results of those assessments, the regulators developed and implemented proportionate CCR requirements for smaller banks (with limited derivative exposures) that meet specific thresholds and criteria to use simplified methodologies.

2.6 Based on these experiences, the Regulatory Authority has given further consideration to the proposed design of its CCR framework in order to take closer account of the CCR risks QFC banks face through their business models. In that connection, the Regulatory Authority has more specifically examined the framework developed by the Australian Prudential Regulation Authority which has developed its CCR methodology based on a modified version of the Current Exposure Method (“CEM”) from the Basel II framework and some elements of the new SA-CCR.

2.7 The Regulatory Authority proposes that QFC banks, which have limited derivatives exposures, use a modified approach to calculate CCR exposures. Therefore:

a. to determine its risk weighted assets, a QFC bank must calculate a CCR exposure amount and then apply the relevant risk weight. The CCR exposure amount is the credit equivalent amount (“CEA”) calculated according to the modified CEM (draft rule 4.4.109):

i. to calculate the CEA of its market-related contracts, a QFC bank shall add together: the CEA for market-related transactions that are not covered by a bilateral eligible netting agreement (draft rule 4.4.144 (3));

ii. the CEA for OTC derivatives transactions that are covered by a bilateral eligible netting agreement (draft rule 4.4.144 (4)); and

iii. adjusting the sum for eligible collateral (draft rule 4.5.16).

2.8 Draft rule 4.4.110 also provides for authorised firms to use CRM techniques to reduce default risk. The main CRM rule provisions are set out in the proposed rule Part 4.5, which was released for consultation in June (see Consultation Paper N. 2021/01).

**Capital charge for CVA risk**

2.9 CVA risk captures changes in counterparty credit spreads and other market risk factors. Under the BCBS counterparty credit risk and market risk frameworks, the CVA risk capital requirement is calculated for a bank’s total CVA portfolio on a standalone basis. The calculation takes into account risk-reducing effects, such as netting, collateral arrangements and certain offsetting hedges.

2.10 There are three approaches available for calculating CVA risk:

a. the standardised approach (“SA-CVA”), which is an adaptation of the standardised approach for market risk and requires supervisory approval;

b. the simpler basic approach (“BA-CVA”); and
c an alternative approach for banks with less engagement in derivatives activities in which they can choose to use their CCR capital requirement charge as a proxy for their CVA charge; i.e. any bank below a specified materiality threshold may choose to set its CVA capital requirement equal to 100% of the bank’s capital requirement for counterparty credit default risk.

2.11 Under the alternative approach, a bank’s relevant supervisory authority can remove this option if it determines that CVA risk resulting from the bank’s derivative positions materially contributes to the bank’s overall risk.

2.12 Considering that the level of derivatives transactions of QFC banks is well below the threshold set in the BCBS framework, the Regulatory Authority proposes to allow QFC banks to adopt the alternative approach to use their CCR capital requirement charge as a proxy for their CVA charge (draft rule 4.4.112 (2)).

2.13 A bank that meets the materiality threshold and the criteria to use the alternative approach may still apply to the Regulatory Authority for approval to determine its CVA risk capital requirement under the BA-CVA or SA-CVA (draft rule 4.4.112 (4)).

**Counterparty credit risk exposures arising from SFTs**

Capital charge for default risk

2.14 Under the BCBS framework, the CRM approach applies to SFTs. Therefore, the proposed framework requires a bank to calculate the default risk exposure by calculating the CCR exposure amount in line with the corresponding CRM methods; and applying the corresponding risk weight according to the proposed rule Part 4.5 Credit risk mitigation (draft rule 4.4.107 (2)).

Capital charge for CVA risk

2.15 Under the BCBS framework, CVA risk is only applied to SFTs if the transactions are fair valued for accounting purposes. Therefore, bilateral SFTs are not subject to a CVA risk capital charge unless the Regulatory Authority has determined that the bank’s CVA loss exposure arising from SFTs is material and has notified the bank that it must apply a CVA risk capital charge of a specified amount or calculated in a specified way (draft rule 4.4.107 (3)).

3 **Proposed amendments to calculate the capital charge for centrally cleared transactions**

3.1 The BCBS standard on capital requirements for bank exposures to Central Counterparties (“CCPs”) contains:

- a capital requirements for trade exposures to Qualified CCPs (“QCCPs”) and non-qualifying CCPs. Banks transacting with QCCPs benefit from a significantly lower capital requirement;
- b an explicit cap on capital requirements for exposures to QCCPs so those charges cannot exceed the charges that would be applied if the CCP were non-qualifying;
- c a specific treatment for posted collaterals;
- d a new approach for determining the capital charge for default fund exposures to QCCPs;
- e the use of SA-CCR in the calculation of bank’s trade derivatives’ exposure; and
- f a specific treatment of multi-level client structures.
The Regulatory Authority proposes to address the BCBS standard on capital requirements for bank exposures to CCPs as set out below:

a) Exposures from transactions cleared through QCCPs – the proposed framework requires QFC banks to undertake a precise assessment of their exposures and apply the appropriate risk weight for calculating the capital charge. In that connection, the risk weights vary depending on whether the bank is exposed to the QCCP itself, another clearing member, or the ultimate client of the transaction (draft rule 4.4.120);

b) Posted collateral – while calculating the CCR incurred, it is proposed that banks should take into account whether the collateral is actually segregated from the QCCP’s own assets or merely identified in the name of the ultimate client. As a result, the risk weight may vary between 2% and the risk weight assigned to the custodian, depending on the risks assumed by the bank (draft rule 4.4.130);

c) Capital charge for default fund exposures to QCCPs – it is proposed that the calculation of the risk weights assigned to such exposures takes into account the bank’s share in the total fund as well as the QCCP’s hypothetical capital requirement. Depending on the values those parameters assume, the risk weight may be as low as 2% (draft rule subdivision 4.4.D4);

d) Use of modified method based on CEM - The BCBS standard contains the use of the SA-CCR to calculate banks trade derivatives’ exposures. As the Regulatory Authority proposes a modified method based on CEM instead of implementing the SA-CCR, the proposed framework requires firms to use this modified approach to calculate trade derivatives’ exposures (draft rule 4.4.121). The proposed approach is designed to be simpler for banks, but at least as conservative as the SA-CCR uses for this calculation; and

e) Multi-level client structures - The BCBS standard includes specific treatment for multi-level client structures, which allows a lower-level client bank transacting with a higher-level client to obtain the same concessional risk weights available to a client bank transacting directly with a clearing member to the QCCP. The Regulatory Authority proposes not to incorporate this treatment to avoid undue complexity and on the understanding that multi-level client structures are not widely used by QFC banks.

Risk management requirements for centrally cleared exposures and clearing member banks

The Regulatory Authority is also proposing to introduce a range of qualitative risk management requirements to support the new quantitative requirements for centrally cleared exposures. These include the following:

a) a requirement for a bank to establish a process for monitoring and reporting all its exposures to CCPs to Senior Management and material exposures to the Governing Body (draft rule 4.4.134 (1) and 4.4.134 (2));

b) a requirement for a bank to maintain adequate capital for its exposures to CCPs and that it must consider whether it might need to hold capital in excess of the minimum capital requirements (draft rule 4.4.134 (3)); and

c) a requirement for a clearing member bank to undertake appropriate scenario analysis and stress testing of whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of those exposures (draft rule 4.4.134 (4)).

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2 Default funds consist of resources held segregated at a central counterparty and raised by various parties such as the central counterparty itself or clearing members and that are used as a safeguard in the event of default.

3 The hypothetical capital requirement is calculated in accordance with the Basel standards and considers the QCCP’s exposure to clearing members as well as the corresponding collateral posted.
The Regulatory Authority may require increase of capital

3.4 The proposed framework allows the Regulatory Authority to require banks to hold additional capital. The aim is to address the following matters:

a any situation where the Regulatory Authority considers the bank needs to hold, in relation to its exposure to CCPs, more capital than the minimum required by the Rules; and

b an external assessment such as a Financial Sector Assessment Program (“FSAP”) has found material shortcomings in the CCP or the regulation of the CCP, and the CCP and/or the CCP regulator have not addressed the issues (draft rule 4.4.105).

Consequential amendments

3.5 The introduction of the SA-CCR affects other Basel-related standards which rely on its exposure calculation, such as the leverage ratio, the large exposures standard, capital requirements for central counterparties and investments in equity funds. The current BANK rules include a leverage ratio calculation requirement, and the Regulatory Authority is publicly consulting on BANK rule amendments in respect of the large exposures’ standard, and investments in equity funds. The proposals in the draft Consultation Paper address the capital requirements for central counterparties. On that basis, the Regulatory Authority will assess the overall impact of the SA-CCR on the aforementioned capital calculations currently set out in BANK (or proposed to be included in BANK) during public consultation and make any required amendments to BANK in the finalised draft Rules.

4 Prudential return field test

4.1 Following the closure of the public consultation, the Regulatory Authority proposes to test the prudential returns on CCR with banks over the reporting period from April 2022 to June 2022. Based on feedback from firms, the Regulatory Authority’s financial analysis team will calibrate the overall impact of the quantitative prudential proposals in the draft BANK Rules.

5 Minor change to General Rules 2006

5.1 The Regulatory Authority is proposing to make a minor change to the auditor rules in GENE to clarify the notification requirements for when the appointment of an auditor ends. Article 91 of the QFC Financial Services Regulations requires an auditor to notify the Regulatory Authority about his or her dismissal, non-renewal, resignation etc.

5.2 The Regulatory Authority is proposing to clarify the FSR requirement in the GENE Rules so that auditors are clear about the circumstances where the notification requirement applies.

5.3 The proposed GENE amendments are set forth in Schedule 2 of the proposed draft Banking Business Prudential (Counterparty Credit Risk) and Miscellaneous Amendments Rules 2022, in Attachment 1.

6 Consultation and commencement date

6.1 The Regulatory Authority is proposing a consultation period until 31 March 2022 for the Counterparty Credit Risk Rules. The BCBS extended the implementation date of the SA-CCR from 1 January 2022 to 1 January 2023 due to the COVID-19 crisis⁴, and therefore, the Regulatory Authority is proposing that the final Rules commence on 1 January 2023.

6.2 The Regulatory Authority is proposing a consultation period until 28 February 2022 for the GENE amendments and the final Rules to commence on 1 April 2022.

END