Astana Financial Services Authority

Consultation Paper

No. 5 of 2018

Proposed Banking Business Rules (BBR Rules)

June 14, 2018

Introduction

1. The Astana Financial Services Authority (AFSA) has issued this Consultation Paper to invite public comments on the proposed rules intended to establish a sound regulatory framework for the conduct of banking business activities in the AIFC. The proposed rules and the associated guidance to comply with those rules are in full compliance with the AIFC legal and regulatory framework. The proposed rules are also consistent with the Basel standards which form the global standard for banking regulation. The proposed rules and associated guidance are set out at Annexures A & B to this Paper.

2. The proposals in this Consultation Paper will be of interest to Authorised Persons, Designated Non-Financial Business or Professions, Registered Auditors and individuals, financial organizations and investors who are interested in doing business in the AIFC. In particular, the proposed rules presented for consultation by way of this paper will be of interest to any banks or financial institutions or investors interested in potentially setting up a bank in the AIFC.

3. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use "Consultation Paper No 5" in the subject line. You may, if relevant, identify the organisation you represent when providing your comments. The AFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise. Comments supported by reasoning and evidence will be given more weight by the AFSA.

4. The deadline for providing comments on the proposals is **13 July 2018**. Once we receive your comments, we shall consider if any refinements are required to this proposal.

5. Comments to be addressed by post:

   Policy and International Relations
   Astana Financial Services Authority (AFSA)
   8 Kunayev Street, Building B, Astana, Kazakhstan
   or emailed to: consultation@afsa.kz
   Tel: +8 7172 613781

6. The remainder of this Consultation Paper contains the following:
   (a) background to the proposals;
   (b) the list of key elements of the proposed AIFC BBR Rules;
   (c) Annex 1: The draft of proposed rules for the AIFC BBR Rules.
   (d) Annex 2: The draft of proposed guidance in the form of Capital Adequacy Guideline (CAG) to the AIFC BBR Rules.
   (e) Annex 3: The draft of proposed amendments to AFSA's GEN, COB and AML rules.

Background

1. In 2015 Astana was designated by the President of Kazakhstan as the location of the Astana International Financial Centre ("AIFC"). He stated the need to establish the AIFC on the base of the Expo-2017 infrastructure and to confer a special status on the AIFC. The AIFC participants, bodies and organisations will enjoy a special tax regime, special migration regime, special currency exchange regulation regime.

2. According to Article 2 of the Constitutional Statute of the Republic of Kazakhstan "On the Astana International Financial Centre" (the "Constitutional Statute"), the purpose of the AIFC is to establish a leading international centre for financial services. The objectives of the AIFC are as follows:

   (1) attracting investment into the economy of the Republic of Kazakhstan by creating an attractive environment for investment in the financial services sphere;

   (2) developing a securities market in the Republic of Kazakhstan and integrating it with international capital markets;

   (3) developing insurance markets, banking services, and Islamic finance markets, in the Republic of Kazakhstan;

   (4) developing financial and professional services based on international best practice;

   (5) achieving international recognition as a financial centre.

3. Further development of the AIFC legislation requires the establishment of a comprehensive framework for provision of the full range of financial services in the AIFC. According to Article 2 of the Constitutional Statute, as mentioned above, one of the objectives of AIFC is developing insurance markets, banking services, and Islamic finance markets in the Republic of Kazakhstan.

4. In this regard, the AFSA as financial regulator of the AIFC strives to develop legislation for banking services in the AIFC by drafting and/or amending relevant AIFC Acts to build enabling regulatory framework for operating banks in the AIFC. This consultation paper invites comments from the public on the proposed rules and the associated guidelines to implement the enabling legal and regulatory framework for providing the full range of banking services in the AIFC that will help to achieve the strategy of the AIFC, in a manner consistent with the regulatory objectives of the AFSA.

KEY ELEMENTS OF THE PROPOSED RULES

Objectives

5. The principal objectives for the initiative to develop and implement a regulatory regime for banking business in the AIFC are as follows:

- Establish a proportionate regulatory regime for banking business
- Achieve compliance with the primary global standard for banking business - the Basel framework
- Achieve high degree of safety and soundness for banks operating in AIFC
- Ensure consistency with the overall structure of the AFSA rulebook; and
- Facilitate entry, establishment and sustainable growth of banking business in AIFC.

Overall policy approach

6. The overall policy approach for the development of the proposed regulatory framework for banking services is focussed on ensuring compliance with the Basel standards for banking regulation. A high level of emphasis has been applied on ensuring that the proposed regulatory framework is appropriately calibrated to avoid any undue regulatory burden while enabling the AFSA to achieve safety and soundness in the banks operating in the AIFC. The AFSA has adopted a comprehensive approach towards policy development for banking business in AIFC, with the intention of covering all relevant regulatory aspects applicable to banking business. This Consultation Paper also proposes amendments to other AFSA Rules including GEN, COB and AML to address the complementary elements of the regulatory framework required for the successful development of banking business in the AIFC. Hence, the Consultation Paper and the proposals covered by it are not restricted to the development of prudential and other regulatory rules for banking.

7. The overall policy approach underlying the development of the regulatory regime (the “BBR Rules”) for banking business and related financial services activities in AIFC is based on the following key principles:

- Ensuring that the BBR Rules comply with the Basel framework in a proportionate manner, and in particular comply with Basel IV capital and liquidity requirements
- Ensuring that the BBR Rules comply with relevant Basel Core Principles for Banking Supervision , set out in annexure 1 to this Policy Paper
- Achieving global standards in risk management for banks in AIFC, including but not limited to Basel standards for risk management

- Benchmarking the regulatory standards to globally reputed jurisdictions – especially the DIFC, QFC, MAS, European framework.
- Achieving a high level of consistency with the existing Financial Services Framework and the General Legal Framework, but making any amendments needed for banking business in the AIFC
- Ensuring a level playing field with Islamic Banks

8. The development of the policy approach and drafting of the rules has been benchmarked to the regulations prevailing in established international jurisdictions including successful peer jurisdictions like the Dubai International Financial Centre. The Basel framework, including but not limited to risk management, governance and, prudential standards covering various relevant aspects of banking regulation, as published by the Basel Committee for Banking Supervision ("BCBS") forms the basis for the detailed rules proposed for this consultation.

Scope of the proposed BBR rules and other amendments

9. This Consultation Paper covers not only rules for prudential regulation of banking activity and resulting risks, but also the rule amendments required in GEN, COB and AML rules of the AFSA, which address the consequential impact of the start of banking business in the AIFC. This consultation covers the regulations for the regulated financial services activities typically carried out as part of banking business, including by credit providers and investment banks. Credit providers are financial services entities which are involved in providing credit but do not accept deposits. Investment banks are typically firms which deal in investments as a principal but not accept deposits. These activities would need to be added to the list in Schedule 1 to the GEN Rules as Regulated Activities in the AIFC. The policy choices consequent on this would form the basis of the proposed BBR Rules.

10. Essentially, the prudential component of the proposed BBR Rules would address only activities which involve prudential risks arising from financial service activities that banks engage in. The definition of scope of the prudential rules for banks is consistent with that adopted for the scope of IBB rules, which ensures consistency and level-playing field between conventional and Islamic banks.

11. The policy approach towards definition of banking business is based on the authorisation for the Regulated Activity of "Accepting Deposits. Proposed amendments to GEN include the definition of this regulated activity in schedule 1 of GEN along with its definition. So, any firm licensed to conduct that regulated activity is defined as a Bank and such Banks would be subject to the rules in BBR, COB and in AML.

12. It is proposed that the regulatory regime would allow the banks operating in the AIFC to provide various banking services to clients who are eligible to be classified as Professional Clients or Market Counterparties, in accordance with the client classification provisions in AIFC COB rules. Banks operating in the AIFC would be prohibited from accepting deposits from retail clients, as defined in AIFC COB rules.

Overview of the amendments to other AFSA Rules

13. This Consultation Paper includes the proposed amendments to the GEN, COB and AML modules of the AFSA rules to address the critical regulatory issues required to regulated banking activity in the AIFC, in an effective manner. The proposed amendments to these rules include, but are not limited to:

- Inclusion of the Regulated Activities of accepting deposits, providing credit, providing money services, advising and arranging credit in Schedule 1 of GEN, along with their definitions.
- Inclusion of a licensed function of Risk Manager for banks in GEN rules;
- Rules prohibiting acceptance of deposits from retail clients in COB rules;
- Enhanced conduct requirements in respect of terms of business for banking products and services in COB rules;
- Rules addressing AML issues for correspondent banking, wire transfers and shell banks.

14. The inclusion of regulated activities like advising and arranging credit would be useful for supporting launch and operation of Fintech activities in the AIFC. The version of GEN, COB and AML rules of the AFSA with the proposed amendments are attached to this Consultation Paper.

Critical elements of the proposed BBR rules

15. The proposed BBR rules cover the following key elements which are essentially structured as independent chapters in the BBR.

- Introduction and definitions
- Principles for regulation of Banking business
- Regulatory reporting requirements
- Capital Adequacy – capital ratios, including eligibility criteria for the different components of capital resources, limits on their use
- Credit risk, credit risk mitigation and concentration risk
- Market risk
- Interest-rate risk in the banking book (IRRBB)
- Operational risk
- Liquidity risk
- Group risk, including consolidated capital requirements
- Pillar II of Basel III – ICAAP and individual capital requirement
- Pillar III of Basel III – disclosure requirements

16. The proposed BBR rules are being supplemented with a detailed guideline, called the Capital Adequacy Guidelines (CAG) which is attached to this Consultation Pape. This CAG provides the detailed

descriptions of key concepts, calculation methodologies, formulas, parameters to be used in technical calculations, guidance required for complying with the technical rules involved in BBR and supervisory expectations in regard to various technical rules in the BBR. Banks regulated by the AFSA would be expected to comply with the provisions in the CAG in order to meet the supervisory expectations of the AFSA as well as to demonstrate their full compliance with the rules in the BBR. The CAG does not have any primary regulatory requirements and only provides useful additional information and technical data to facilitate banks in complying with the BBR.

17. The significant components of the proposed BBR rules are explained in the following paragraphs.

Definition of Bank/Banking Business

18. The proposed rules are based on an approach wherein banks are authorised to carry out banking activities on the basis of license they receive from the AFSA for the regulated activity of Accepting Deposits. For this purpose, this regulated activity has been included in the proposed amendment to schedule 1 of GEN rules. Centre Participants authorised to "Accept Deposits" would thus be treated as banks and would have the privilege of carrying out all supplementary or auxiliary banking activities (except other Regulated Activities for which they were not additionally authorised) like cheque clearing and settlement, payment services, money services and foreign exchange services etc.

19. Centre participants authorised to carry out other Regulated Activities like Providing Credit or Dealing in investment as Principal while not carrying the license for accepting deposits would not be allowed to provide the supplementary or auxiliary banking activities listed above. Such regulated entities would be referred as banks in BBR, only for the purpose of simplifying the rules as a majority of the proposed BBR rules would apply to such firms.

Capital Adequacy

20. The proposed BBR rules outlining the capital adequacy requirements in Chapter 4 of the BBR are fully consistent with the Basel III framework, the global standard for prudential regulation of banks. This is consistent with the fundamental policy approach of ensuring consistency with applicable global standards. Consequently, all the detailed rules in Chapter 4 of BBR, implement the components of Basel III diligently.

21. In respect of the prudential regime for banks operating as branches in the AIFC, it is proposed that the capital requirements would not apply to such branches. Instead, the required level of oversight, monitoring and ability to apply capital requirements would be at the discretion of the supervisors of the AFSA. The discretion on applying capital requirement to a branch is expected to be used only in extremely rare cases. The effectiveness of this approach can be enhanced significantly by restricting the jurisdictions from where branches would be allowed

and by entering into closer supervisory cooperation with the lead regulators of those jurisdictions.

22. The capital adequacy rules of Basel III include two main components – definition of capital resources (with eligibility criteria) and calculation of capital requirements (based on calculation of Risk-weighted Assets - RWAs). In respect of the first component, a bank's total Capital Resources is defined as the sum of its Tier 1 Capital and Tier 2 Capital. The proposed rules in chapter 4 of the BBR provide definitions of T1 and T2 capital, the eligibility criteria for inclusion in those categories of capital as well as the limits of usage of the different categories of capital, which are strictly identical to those of the Basel framework.

23. The proposed BBR Rules restrict a bank from reducing its capital resources without the AFSA's written approval. The AFSA will also be able to require a bank to have capital resources, comply with any other capital requirement or use a different approach to, or method for, capital management. The AFSA will be able to require a firm to carry out stress-testing at any time.

24. In respect of the second component of defining capital requirements, the proposed BBR rules include a minimum base capital requirement (BCR) and risk-based capital (RBC) requirements. The proposed BBR rules require a bank to meet the higher of the two – BCR and RBC requirements. The BCR being minimum also operates as the threshold entry requirement for a new bank and the BCR is expected to be met at the point of licensing. The BCR is required to be met with the common equity capital of the bank.

25. The thresholds proposed for the BCR are as follows:

- Bank / Accepting deposits — USD 10 million
- Broker Dealer / Dealing in investment as Principal— USD 2 million
- Credit Provider / Providing credit only – USD 2 million.

26. The proposed BBR Rules require Banks and other centre participants subject to it (Credit Providers and Broker Dealers) covered by it to meet minimum risk-based capital requirements based on risk exposures in the categories of credit risk, market risk and operational risk. The methodology of measurement of risk exposures in these categories and consequent calculation of capital requirements to address these risk exposures specified in the proposed BBR Rules are fully consistent with the Basel III framework.

27. The basic requirement is for a bank to meet or exceed, at all times, regulatory capital ratios, which are defined as a percentage of the total RWAs of the bank. The proposed BBR rules specify a total capital requirement expressed as a percentage of risk-weighted assets (RWA) at 8% of RWA, which is consistent with Basel framework. The recommended level is also consistent with AFSA's IBB rules for Islamic banks. This approach would preclude any potential for regulatory arbitrage and ensure level playing field between Islamic and conventional banks operating in the AIFC.

28. The proposed BBR rules include the following regulatory minimum thresholds for the risk-based capital requirements:

- 4.5% of RWA for CET 1 Capital ratio
- 6% of RWA for Tier 1 Capital ratio
- 8% of RWA for Total Capital ratio
- RWAs include Credit RWA, Market RWA and Operational RWA
- Capital Conservation Buffer at 2.5% of RWA

These thresholds are consistent with those applicable to Islamic Banks in AIFC.

29. The proposed BBR Rules do not allow banks to use their own internal models to measure risk exposures for the purposes of determination of their capital requirements (Advanced approaches or IRB approaches under Basel framework). So, the capital adequacy determination rules would be limited to standardised approach. The use of internal models is restricted to very few limited areas of market risk capital determination and in such cases, internal models proposed for usage would have to be pre-approved by the AFSA.

30. In respect of each of the significant risks faced by a Bank, the BBR rules set out in individual chapters for each of those risks, involve two components:

- Governance, systems and controls requirements; and
- Determination of risk-based capital requirement to support the risk exposures involved, including detailed metrics and methodologies involved.

31. The proposed BBR rules set out detailed requirements for the governance, systems and controls to address and manage each of the key risk categories as illustrated in paragraph 16 above. The chapters 5 to 9 of the proposed BBR address each of those key risk categories. The proposed BBR rules also include specific methodologies for the calculation of RWAs for credit, market and operational risk categories. The proposed BBR rules in these chapters are fully compliant with the Basel framework. The proposed guidelines in CAG includes the methodologies, formulae and parameters to support the process of calculation of RWAs and risk capital requirement as described in paragraph 17 above.

32. The AFSA will have power to specify additional capital requirements in cases where it has a basis to determine that a bank has risk exposures which are beyond those addressed within the BBR Rules or has risk exposures which cannot be measured as part of the RWA. The AFSA will be able to do this either using its general supervisory powers or through the operation of the pillar II process – the ICAAP requirement, being proposed as part of this policy paper.

33. It is proposed that the BBR Rules include provisions which restrict a bank from reducing its capital resources without the AFSA’s written

approval. The AFSA will be able to require a bank to have capital resources, comply with any other capital requirement or use a different approach to, or method for, capital management. The AFSA will be able to require a firm to carry out stress-testing at any time.

Managing credit, market and operational risks

34. The proposed BBR Rules impose regulatory requirements on a bank to establish, implement and maintain robust risk management systems and controls, which are appropriate for the nature, scale and complexity of its business and for its risk profile. The proposed rules, guidance and standards for management of all risk categories applicable to banking business, including but not limited to credit, market and operational risks, interest rate risk in the banking book (IRRBB) and liquidity risks, are compliant with the various risk management standards forming part of the Basel III framework.

Capital buffers

35. The Basel III capital adequacy framework contains 2 measures imposing additional capital requirements on Banks through the Capital Conservation Buffer and the Counter-Cyclical Capital Buffer. The Capital Conservation Buffer (CCB) is an additional layer of protection which will prevent banks from breaching minimum capital requirements. CCB acts as preventive alert mechanism by providing a period of time in which the regulator and the bank can take steps to stem the erosion in capital and restore it to healthy levels The Counter-Cyclical Capital Buffer (CCCB) is a macro-prudential tool that can be used when excess aggregate credit growth is judged to be associated with a build-up of a system-wide risk. It is intended to ensure that the banking system has a buffer of capital to protect it against future potential losses.

36. The proposed rules in chapter 4 of the BBR, include provisions requiring a Bank in the AIFC to maintain CCB at all times. These rules require a Bank to have adequate systems and controls to ensure that the amount of distributable profits and maximum distributable amount are calculated accurately. A bank must be able to demonstrate that accuracy if directed by the AFSA. If a bank’s CCB falls below the required minimum, the bank must immediately conserve its capital by restricting its dividend distributions. The proposed BBR Rules are fully compliant with the Basel framework. The proposed BBR rules do not implement the CCCB requirement, given that the CCCB is a macro-prudential measure which is aimed at addressing the accumulation of risks in an economy (Kazakhstan in this case) and has to be applied to all credit providers to be effective in achieving its goals.

Leverage ratio

37. Basel III introduced a non-risk based Leverage Ratio (“LR”) requirement alongside the risk-based capital ratios as a “back-stop” to restrict the build-up of excessive leverage in the banking sector, which was identified as one of the key factors contributing to the global financial crisis. The BCBS issued the LR framework together with the associated

disclosure requirements in January 2014. Chapter 4 of the proposed BBR, includes specific requirements for Banks to meet the LR, in a manner fully consistent with the Basel framework.

Liquidity risk management

38. The proposed BBR Rules located in chapter 9 of the BBR and the supporting guidelines in chapter 9 of the CAG include detailed provisions on liquidity risk management covering both systems and controls as well as quantitative risk measurement techniques and control limits, which are consistent with Basel III standards. The proposed rules include provisions to implement LCR and NSFR, two key components of Basel III. The implementation of these two metrics in the proposed BBR rules makes the AIFC's banking regime compliant with Basel III.

Managing group risk

39. The purpose of group risk requirements under the proposed BBR Rules is to ensure that a bank takes into account the risks related to its membership of any financial group and maintains adequate capital resources so as to exceed its financial group capital requirement. Under the rules a bank may apply to the AFSA for approval to exclude an entity from its financial group. The AFSA will grant such an approval only if the bank satisfies the AFSA that inclusion of the entity would be misleading or inappropriate for the purposes of supervision. The AFSA would consider a range of factors when requiring a Bank to treat another entity as part of its financial group. These factors would include regulatory risk factors, including direct and indirect participation, influence or contractual obligations, interconnectedness, intra-group exposures, intra-group services, regulatory status and legal framework. These proposals are broadly consistent with the overall regulatory objectives of AFSA and related Basel standards. The proposed rules in Chapter 10 of the BBR also extend the application of concentration risk limits applicable to a Bank to its Financial group as well. In that rule, the limits are specified as a percentage of the financial group's capital and they apply to the credit risk exposures of the financial group as a whole.

Internal Capital Adequacy Assessment Process (ICAAP)

40. The BBR Rules include provisions implementing the pillar II process of Basel III framework, and require a bank to carry out an internal capital adequacy assessment process or ICAAP. The rules located in chapter 11 of the BBR impose requirements on the ICAAP process of a Bank, and the tools involved in the process. These rules also require a bank to demonstrate that it has implemented methods and procedures to ensure, on an ongoing basis, that it has adequate capital resources to support the nature and level of its risks and reflect the nature scale and complexity of operations.

41. The proposed BBR Rules require a Bank to carry out an assessment under the bank's ICAAP process on an annual basis, and submit a report documenting the outcome of the ICAAP assessment to the AFSA

at least once in every 12 month period. The proposed rules also describe the supervisory review and evaluation process (SREP) in which the regulator (AFSA) commits to a process of review and evaluation of the ICAAP report submitted by a bank. The proposed rules also allow the AFSA to impose additional capital requirement on an institution-specific basis in excess of the minimum capital requirements applicable to all banks – Individual Capital Requirements (ICR).

Disclosure requirements

42. The proposed rules in Chapter 12 of the BBR, include provisions implementing the pillar III of Basel III framework, which requires banks to disclose all relevant and material risk information to facilitate the process of market discipline. These rules along with the supporting guidelines in chapter 13 of the CAG require a bank to make detailed disclosures which are specified in a detailed tabular format. These proposed rules are fully consistent with the requirements in pillar 3 of the Basel framework.