Consultation Paper

AFSA-P-CE-2022-0004

Proposed Amendments to the AIFC Banking Business Framework

Unrestricted

July 08, 2022

Introduction

Why are we issuing this Consultation Paper (CP)?

1. The Astana Financial Services Authority (AFSA) has issued this Consultation Paper to seek suggestions from the market on the proposed Amendments to the AIFC Banking Business Framework.

Who should read this CP?

2. The proposals in this paper will be of interest to current and potential AIFC participants who are interested in exercising business activities in or from the AIFC, especially in the capacity of a Credit Provider.

Terminology

3. Defined terms have the initial letter of the word capitalised, or of each word in a phrase. Definitions are set out in the Glossary Rules (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

4. We invite comments from interested stakeholders on the proposed framework. 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 AFSA-P-CE-2022-0004" 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.

5. The deadline for providing comments on the proposed framework is **08 August 2022**. Once we receive your comments, we shall consider if any refinements are required to this proposal.

6. AFSA prefers to receive comments by email at consultation@afsa.kz

   Comments may also be posted to:
   Policy and Strategy Division
   Astana Financial Services Authority (AFSA)
   55/17 Mangilik El, building C3.2, Kazakhstan

Structure of this CP

Part I – Background;
Part II – Key proposals;
Part III – Questions in this consultation paper;
Annex 1 – Proposed amendments to the AIFC Banking Business Framework

Part I - Background

Prior to December 2021, the AFSA's framework excluded the Regulated Activity of Providing Credit from own funds from the definition of Credit Provider and entirely disapplied the AIFC Banking Business Prudential Rules (BBR) to such firms. The BBR and the rest of the AIFC Legal Framework did not further specify what prudential framework such firms should be subject to instead.

In addition, prior to December 2021, exclusion in respect of intergroup activities (AIFC General Rules (GEN) 1.1.12) from being considered as regulated activities by the AFSA did not include Credit Providers.

Jurisdictional comparisons as well as international standards analysis showed that this practice was unusual when compared to other leading financial centres, in that

1) when credit is provided by way of business, relevant prudential requirements apply regardless of source of funds used;
2) providing credit within the same group or enterprise does not qualify as a regulated activity, on the basis of the group exemption or when not being provided "by way of business";
3) in some jurisdictions, a captive finance activity is used to provide credit to third parties using the company's own funds (often to support the sales of equipment or other products provided by the same group).

To mitigate these risks and to align the AIFC legal framework with international practice, in December 2021, the AFSA has made the following amendments to its Banking Business Framework:

1) removed clause 5 of BBR 1.7 to formally apply the BBR to all credit providers regardless of their source of funds;
2) amended the GEN 1.1.12 to recognise providing credit within the same group or enterprise as an activity that is not regulated by the AFSA;

The existing participants were then provided with a six-month transition period to comply with the outcomes of the amendments. This period expired on 12 June 2022, and currently Credit Providers, both existing and new, have to adhere to the BBR considering the amendments made in December 2021.

Because all references to a Bank in the BBR are read as referring also to Credit Providers, in 2022 the AFSA has analysed the BBR to ensure effective and fair prudential regulation of Credit Providers considering their differences from Banks. This Consultation Paper includes the proposals that resulted from this analysis. Additionally, this Consultation Paper envisages provisions of captive finance activities from the AIFC, which involve subsidiaries that typically finance purchases of equipment (for example, construction equipment and trucks) from their parent.

In preparing the proposals in this Consultation Paper, AFSA has analysed the best practice jurisdictions such as Qatar Financial Centre (QFC), Dubai International Financial Centre (DIFC), Abu Dhabi Global Market (ADGM), Kazakhstan and partially the UK. The market differences as well as regulatory objectives of these jurisdictions analysed in regard to categorization of banking business firms, setting capital adequacy and risk requirements to them. The AFSA also paid special attention to Basel Core Principles of Banking Supervision, as adhering to the principles of standard setting bodies is of high priority for the AFSA. Additionally, the differences of so-called non-banking financial institutions were considered to justify differences taken in various regulatory approaches.

Part II - Key proposals

Considering the above AFSA has made the following policy proposals, some of which resulted in draft amendments to the AIFC Banking Business Framework (Annex 1):

To maintain the base capital requirement differentiated as-is (10 million USD for deposit takers and 2 million USD for credit providers).

To apply the calculation of leverage ratio to Credit Providers. The leverage ratio is a simple, transparent, non-risk-based measure to help monitor the build-up of leverage in the banking system and monitor financial risks.

To exempt Credit Providers in the AIFC from the requirement to maintain funding strategies that provide effective diversification in the source and nature of their funding. This exemption is aimed at accommodating Credit Providers who provide credit using their own funds.

To maintain the exemption of credit providers in the AIFC from meeting quantitative liquidity requirements (LCR and NSFR). This accords with international practice and the Basel Core principles.

As the 6-month transition period given to the existing Credit Providers in the AIFC has passed, they are now required to maintain an ongoing capital highest of their base capital requirement or risk-based capital requirement, regardless of source of funds used for crediting.

AFSA considers that expenditure based capital minimum is intended to capture the actual expenses incurred and the amount of liquid assets maintained. It differs for credit providers depending on holding of client assets (34% of annual expenditure if yes and 25% if not).

Further, ASFA proposes to introduce a commercial captive finance regime in the AIFC under the credit provider license. The base capital requirement is proposed for such firm at 500,000 USD on the basis that captive financiers that would not raise funds through, for example, debt instruments, would be solely limited to parent firm funding, presenting a lower risk. Systems and controls, risk management requirements, group risk requirements would apply to commercial captive finance companies proportionately to their risk on a case-by-case basis in the course of supervision.

AFSA proposes to also make minor amendments to the AIFC BBR by way of corrections.

Part III - Questions in this consultation paper

1. Would introduction of expenditure-based capital requirement as one of the elements of minimum capital requirement alleviate the capital adequacy requirement for Credit Providers? If implemented, the minimum capital requirements would be considered the highest of base capital requirement, risk-based capital requirement or the expenditure-based capital requirement. Please refer to the Proposals section for the explanation of expenditure-based capital minimum.
2. Would it entail any difficulty for Credit Provider to calculate Leverage Ratio, according to the AIFC BBR?
3. Do you find the commercial captive finance regime attractive? As a potential captive finance entity, what would be your loan portfolio, group structure and risk exposure?
4. Question for existing Credit Providers in the AIFC: what would be an appropriate timeframe to bring your entity in compliance with the proposed changes?

Annex 1 to the Consultation Paper

on Amendments to the AIFC Banking Business Framework

PROPOSED AMENDMENTS TO THE AIFC RULES

In these Rules, underlining indicates a new text and strikethrough indicates a removed text

AIFC Banking Business Prudential Rules

1.7 Credit Provider

(1) An Authorised Firm is a Credit Provider if it is authorised to conduct the Regulated Activity of Providing Credit and it is not a Bank.
(2) Credit Providers may raise funds from capital markets or money markets using debt instruments of any type but must not accept Deposits.
(3) An Authorised Firm is a Credit Provider even if it is also authorised to conduct any Regulated Activity (except Accepting Deposits). The authorisation for Providing Credit and the absence of an authorisation for Accepting Deposits qualifies an Authorised Firm as a Credit Provider.
(4) A Credit Provider may conduct the Regulated Activity of Dealing in Investments as Principal, if it receives the necessary authorisation from the AFSA.
(5) The Regulated Activity of Providing Credit is taken to include the activity of providing Commercial Captive Finance. The BBR applies to a Credit Provider providing Commercial Captive Finance on a risk-proportionate basis, where AFSA may have regard, including but not limited to, to the firm's scale and complexity, business model, customer base and engagement in capital or money markets.

4.10 Base Capital Requirement

The Base Capital Requirement is:
(a) for a Bank — USD 10 million;
(b) for a Broker Dealer — USD 500,000;
(c) for a Credit Provider – USD 2 million;
(ca) for a Credit Provider providing only Commercial Captive Finance – USD 500,000;
(d) for an Authorised Firm Arranging Credit Facility – USD 10,000;
(e) for an Authorised Firm Advising on Credit Facility – USD 10,000;
(f) for an Authorised Firm Providing Money Services – USD 200,000.

Section 4F Leverage Ratio

4.36 ~~Application~~ [Intentionally omitted]

~~The rules in this section apply only to Banks. For the sake of clarity, the rules in this section apply only to Banks licensed by the AFSA to conduct the Regulated Activity of "Accepting Deposits".~~

…

9.8 Funding Strategy

(1) A Bank must establish, and must regularly review, strategies for the ongoing measurement and monitoring of funding requirements. The resultant funding strategy must provide effective diversification in the source and nature of its funding.

Note Subrule (1) of Rule 9.8 does not apply to Credit Providers.

(2) A Bank must ensure that the funding strategy is documented and is approved by its Governing Body. A Bank must ensure that its funding strategy is reviewed regularly and at least annually and

is updated as necessary in light of changed funding conditions and any change in the Bank's strategy.

(3) The Bank must promptly inform the AFSA of any material changes to its funding strategy.

(4) A Bank must assess regularly its capacity to raise funds quickly. A Bank must assess market access under a variety of normal and stressed conditions.

(5) A Bank must:

(a) develop and document a 3-yearly funding strategy;

(b) identify the main factors that affect its ability to raise funds;

(c) monitor those factors closely to ensure that estimates of fund raising capacity remain valid;

(d) maintain a continuing presence in its chosen funding markets; and

(e) maintain strong relationships with funds providers

…

9.16 Liquidity Coverage Ratio (LCR)
(1) The Rules 9.16 to 9.18 apply only to Banks licensed to conduct the Regulated Activity of Accepting Deposits. These rules, regarding compliance with LCR requirement are not applicable to Broker Dealers or Credit Providers.

…

9.19 Net Stable Funding Ratio (NSFR)
(1) The Rules 9.19 to 9.20 apply only to Banks licensed to conduct the Regulated Activity of Accepting Deposits. These rules, regarding compliance with NSFR requirement are not applicable to Broker Dealers or Credit Providers.

AIFC General Rules

1.1.12. Exclusion in respect of acting with or for Group companies
A Person does not carry on any of the Regulated Activities specified in paragraphs 1, 2, 3, 5, 6, 10, 11, 12, 15 or 18 of Schedule 1 where that Person is a Body Corporate and carries on that activity solely as principal with or for other Bodies Corporates:
(a) which are within the same Group as that Person; or
(b) which are or propose to become participators in a joint enterprise and the transaction is entered into for the purposes of or in connection with that enterprise;

and for the purposes of the activities specified in paragraphs 3, 5, 6 and 12 of Schedule 1 the assets in question belong to a Body Corporate falling within (a) or (b).

This Exclusion does not apply to a Credit Provider that only provides Commercial Captive Finance.

Credit Facility
Any facility which includes any arrangement or agreement which extends monetary credit whether funded or unfunded to a Person including but not limited to any loan or syndicated loan, mortgage, overdraft, financial lease, letter of credit, financial guarantee, trade finance, transaction finance, project finance, ~~or~~ asset finance~~.~~ or, where applicable, captive finance.

Commercial Captive Finance
as an activity of an entity (the captive financier), means providing finance to a commercial customer to enable the customer to lease or purchase (through finance lease, operating lease, hire-purchase or a similar form) an asset (usually immoveable properties, machinery, vehicles and equipment) from the captive financier's parent entity or from a member of the parent entity's group.

Technical Amendments (to eliminate typos)

AIFC BBR

5.13 Policies—foreign exchange rollovers
(1) A ~~b~~Bank must have policies for entering into and monitoring rollovers on foreign exchange transactions and the policies must restrict the Bank's capacity to enter into such rollovers. The Bank must notify the AFSA if it enters into a rollover in breach of its policy. Such rollovers must be approved by the Governing Body of the Bank. The AFSA may direct how the rollover is to be treated for capital adequacy purposes.

(2) A ~~b~~Bank should have systems and controls to identify, monitor, control and report off-market transactions.

(3) ~~The~~ A Bank must not enter into a transaction at an off-market price, unless the transaction is a historical rate rollover on a foreign exchange transaction. A historical rate rollover on a foreign exchange transaction may be entered into at an off-market price (instead of current market price).

8.3 IRRBB Management – Processes and Standards
(1) A ~~b~~Bank must not use an assumption or adjustment relating to the ~~b~~Bank's exposure to IRRBB unless the assumption or adjustment has been approved by its governing body, or a relevant committee of its governing body. The AFSA may require a ~~b~~Bank to seek its explicit approval before using an assumption or adjustment.

(2) If required to do so by the AFSA, the ~~b~~Bank must demonstrate how the Bank used an assumption or adjustment (whether or not the AFSA required the assumption or adjustment to be approved).

(3) A ~~banking business~~ ~~b~~Bank must set a prudent limit on the extent to which floating-rate exposures are funded by fixed-rate sources (and vice versa). In floating-rate lending, the Bank must set a prudent limit to the extent to which it runs any basis risk that would arise if lending and funding were not based on identical market interest rates.

(4) A Bank must set a prudent limit on the extent to which floating-rate exposures are funded by fixed-rate sources (and vice versa). In floating-rate lending, the Bank must set a prudent limit to the extent to which it runs any basis risk that would arise if lending and funding were not based on identical market interest rates.

(5) A Bank must identify the effect of IRRBB before it introduces a new product or activity. The Bank must consider managing the effect through hedging (using swaps or other derivatives).

8.4 Stress Testing and IRRBB
(1) A Bank must carry out an evaluation of its exposure to IRRBB, in each currency in which 5% or more of its Banking Book assets or Banking Book liabilities is denominated. This evaluation must be carried out at least on an annual basis.

(2) A Bank must carry out stress-testing of its exposures to IRRBB at least on a quarterly basis. This stress-testing must:

(a) determine the re-pricing gap between the ~~b~~Bank's assets and liabilities, before and after the effect of derivative instruments is taken into consideration;

(b) determine the effect of a sudden and unexpected parallel change in interest rates of 200 basis points in both directions, on the Bank's net interest income from the forecast Banking Book; and

(c) apply a 200 basis point shock to each material currency in which 5% or more of its Banking Book assets or Banking Book liabilities is denominated.

(3) The AFSA may, in writing, specify a different level of interest rate shock as compared to the standard 200 basis point shock, for specific Banks.

(4) A Bank must include appropriate scenarios in its stress-testing to measure the Bank's vulnerability to loss under adverse interest rate movements. In determining the effect of a rate change on its net interest income, the Bank must not assume that the rate will become negative.

(5) A ~~b~~Bank must report the results of its stress-testing to the AFSA, in the form prescribed by the AFSA.

(6) A Bank must immediately notify the AFSA, if any stress-testing under this Chapter involving an interest rate shock described in (2) above, indicates a potential decline in the economic value of the bank by an amount exceeding 20% of its Total Capital as defined in Chapter 4 of BBR.