

# SELF-ASSESSMENT ON BASEL CORE PRINCIPLES

## **Background**

This document outlines the Dubai Financial Services Authority's ("DFSA") self-assessment of its supervisory policies and practices against the Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision (the Basel Core Principles). The summary is based on the DFSA's complete Assessment on Basel Core Principles which were originally issued in 1997 and most recently revised as of October 2006.

The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. Created in 1974 and meeting regularly four times a year, its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), and representatives from Luxembourg and Spain.

The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision; the purpose of the committee is to encourage convergence toward common approaches and standards.

The DFSA's supervisory practices are continually evolving to align with international best practices, adapted to the context of the DIFC. This self-assessment has been conducted to take stock of the current practices and to determine conformity with the revised Basel Core Principles. It should be noted that the DFSA is the integrated regulator for financial services including banking activities within the Dubai International Financial Centre (DIFC). The DIFC is a Financial Free Zone located in Dubai, one of the seven Emirates of the United Arab Emirates.

## 1 Introduction

The Core Principles for Effecting Banking Supervision (herein referred to as the “Basel Core Principles”), developed by the Basel Committee on Banking Supervision allow bank supervisors to undertake self assessments of their regulatory practices. Basel Core Principles are also used for the following purposes:

- IMF and World Bank assessments of the quality of supervisory systems in the context of the Financial Sector Assessment Program;
- Reviews conducted by private third parties; and
- Peer reviews conducted by other supervisors.

In November 2006, the DFSA finalised a self-assessment of its legislation, rules and supervisory practices against the revised Basel Core Principles. The self-assessment provided an overview of the DFSA’s banking supervisory system at the time of the assessment. This has been updated to 31 October 2007.

During the course of the self-assessment, opportunities were identified where the DFSA could improve its supervisory practices and rules to further align with the Basel Core Principles and as a result, the DFSA initiated the process of making the necessary changes. Where a change required an amendment to the DFSA’s rules, these are documented in **Consultation Paper No. 42 Proposed Enhancements to the DFSA Rulebook to Meet International Best Practice Standards** (the consultation period for this paper is now closed). Changes in supervisory practices and rules have also been reflected in the self-assessment.

## 2 Methodology used for Assessment

The assessment of compliance with each of the 25 principles is made in accordance with the “Core Principles Methodology” Document published in October 2006 by the Basel Committee on Banking Supervision. A Principle is assessed as “Compliant” where all essential criteria are met without any significant deficiencies. A principle is assessed as “Largely compliant” where only minor shortcomings are observed that do not raise any concerns over the DFSA’s intent to achieve full compliance. A principle is assessed as “Materially non-compliant” when the shortcomings are sufficient to raise doubts over the DFSA’s ability to achieve compliance. A principle is assessed as “Non-compliant” where there has been no substantive implementation of the principle. It should be noted that no principle was assessed as Non-compliant during this self-assessment. A principle is assessed as “Not applicable” where the principle is not relevant to the banking system in question.

## 3 General Observations concerning Compliance with Core Principles

Overall, the DFSA achieves a compliant or largely compliant rating against a majority of the core principles. Of the 25 core principles, 13 are rated fully compliant, 11 largely compliant and 1 materially non compliant. The DFSA’s objective that has been determined by its Board and the Management is to be largely compliant for all principles as soon as possible and achieve full compliance over time.

In many instances the DFSA has assessed a principle as largely compliant for reasons of prudence, as we have not yet had sufficient experience in fully demonstrating the effectiveness of our existing laws or rules or regulatory practice. Given the recent increase in firm activity levels, we believe that many of the “Largely Compliant” principles should be reassessed during the next year.

4 Overview of Results

Core Principle		Compliance Rating				
		C	LC	MNC	NC	NA
1	Objectives, independence, powers, transparency and cooperation	X				
2	Permissible activities	X				
3	Licensing criteria	X				
4	Transfer of significant ownership	X				
5	Major acquisitions	X				
6	Capital adequacy	X				
7	Risk management process		X			
8	Credit risk		X			
9	Problem assets, provisions and reserves		X			
10	Large exposure limits		X			
11	Exposures to related parties		X			
12	Country and transfer risks		X			
13	Market risks		X			
14	Liquidity risk		X			
15	Operational risk		X			
16	Interest rate risk in the banking book			X		
17	Internal control and audit	X				

Core Principle		Compliance Rating				
		C	LC	MNC	NC	NA
18	Abuse of financial services	X				
19	Supervisory approach	X				
20	Supervisory techniques		X			
21	Supervisory reporting	X				
22	Accounting and disclosure	X				
23	Corrective and remedial powers of supervisors	X				
24	Consolidated supervision		X			
25	Home-host relationships	X				

\* C = Compliant, LC = Largely Compliant, MNC = Materially Non-Compliant, NC = Non-Compliant, NA = Not Applicable

## 5 Summary of Self-Assessment

**Principle 1: Objectives, independence, powers, transparency and cooperation** *An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

The DIFC Law establishes and defines DFSA as the central body solely responsible for the regulation of financial services and related activities in the DIFC. Article 7 of the DIFC Law also specifies the governance structure of DFSA as well as its responsibilities, powers and functions. The DIFC Law prescribes specific objectives of DFSA including fostering and maintaining the financial stability of the financial services industry in the DIFC, reducing systemic risk and fostering and maintaining confidence in the financial services industry.

As the sole financial services regulator in the DIFC, the DFSA regulates activities as diverse as reinsurance, banking, Islamic Finance, asset management, securities and investments and other ancillary activities.

Article 23 of The Regulatory Law of 2004 provides the necessary powers to DFSA to make rules in respect of minimum prudential standards. The Prudential - Investment, Insurance Intermediation and Banking Business Module (PIB) of the DFSA Rulebook provides a detailed framework of prudential rules for banking business. The PIB Module includes prudential rules covering calculation of capital resources, credit risk, market risk, liquidity risk, group risk and operational risk. The PIB module also specifies the prudential requirements for firms undertaking Islamic financial business.

The DFSA has issued a Policy Statement which describes how and when it co-operates and shares confidential regulatory information with foreign supervisors. In general, DFSA has extensive legislative powers to obtain and retain confidential information on its own behalf and on behalf of foreign regulators, and to share it with foreign regulators.

The International Monetary Fund/ World Bank conducted a publically available review of the DFSA during early 2007. The review ("Detailed Assessment of Observance of IOSCO Objectives and Principles of Securities Regulation for Dubai International Financial Centre" issued November 2007) states, in pertinent part (on page 9), that "the commitment to independence in the legal framework is also honoured in practice and on a day to day operational level."

*Assessed as **Compliant***

**Principle 2: Permissible activities**

*The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.*

The permissible activities of the banks are very clearly defined and outlined to firms in a statement of “permissions.” Licensed activities themselves are set out in the General Module (GEN), in Chapter 2 of the Module and include, accepting deposits and providing credit.

The word “Bank” is clearly defined in the DFSA Rulebook, Glossary Module as “an Authorised Firm, (AF), which holds a License authorising it to carry on either or both of the Financial Services of Accepting Deposits or Providing Credit.”

Section 2.3 of the Companies Regulations deals with the use of names. In particular, Regulation 2.3.2 (e) prohibits the use of the word “bank” in a company’s name unless the DFSA has consented to it in writing.

*Assessed as **Compliant***

**Principle 3: Licensing criteria**

*The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.*

The DFSA’s authority to License banking institutions is established in the Regulatory Law. The Law covers who and what kinds of activities need to be Licensed. These provisions also deal with how Licences are applied for and how they may be withdrawn. The detail of licensing criteria is mainly contained in rules set out in the Authorisation Module of the DFSA Rulebook.

As part of the authorisation process, every applicant must demonstrate that it is fit and proper to be authorised by DFSA. Criteria for fitness and propriety are set out in the Authorisation Module in the form of guidance on fitness and propriety. Within it, the ownership structures of the bank and the manner in which the firm resources itself to organize and conduct its affairs are key criteria.

The DFSA, as part of its risk based framework also assesses the risks and mitigants posed by systems and controls and management and governance. Typically issues like management culture, clarity of reporting lines, risk management, operations and compliance are some of the risk factors that are assessed before authorising institutions to conduct financial services business.

A significant part of the application process involves reviewing the strategic and operating plans of a bank and in ensuring that a robust system of corporate governance is in place. A central part of the application required to be submitted is the firm’s operating plan. As part of the licensing process the DFSA undertakes a risk assessment review of the initial application. The DFSA carefully reviews and tests the assumptions and viability of the plans as well as the firm’s corporate governance.

*Assessed as **Compliant***

**Principle 4: Transfer of significant ownership**

*The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.*

Comprehensive and clear definition of 'significant' ownership is provided in the AUT Module of the DFSA Rulebook which also sets out the requirements for notifications and approvals by the DFSA concerning a change in control.

The DFSA has the authority to reject any proposal for a change in ownership or controlling interest. Further, where the DFSA deems that a Controller is unacceptable, it will notify the Authorised Firm in writing to remove the Controller without undue delay, or take other specified action to the satisfaction of the DFSA.

*Assessed as **Compliant***

**Principle 5: Major acquisitions**

*The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

Chapter 7 of the SUP module, (The Supervision Module of the Rule Book), prescribes rules addressing both domestic firms as well as authorised firms operating as branches. The rules clearly defines a major acquisition which would need prior supervisory approval, as acquisitions made, directly or indirectly to a value of 5% or more of the authorised firm's regulatory capital resources or a smaller acquisition which may reasonably be considered to have a significant regulatory impact on the Authorised firm or on the financial services industry of the DIFC as a whole.

The rules specify the factors or criteria which the DFSA may take into account, for assessing whether the proposed major acquisition is reasonably likely to have a material adverse impact on the authorised firm's ability to comply with its applicable regulatory requirements or whether any undue risks are likely to arise from the proposed acquisition.

*Assessed as **Compliant***

**Principle 6: Capital adequacy**

*Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.*

Rule 2.2.1 of the PIB module requires all authorised firms to maintain, capital resources of at least the amount of minimum capital requirement. The capital requirements are defined as the highest of risk capital requirements and applicable base capital requirements. The defined risk capital requirements, as per PIB rule 2.3.1 prescribes a minimum capital to risk-weighted assets ratio of 10 percent for all banks, which is in excess of what is required under Basel Capital Accord.

Banks are required to ensure that they maintain financial resources, which are adequate in relation to the nature, size and complexity of their business to ensure that there is no significant risk that liabilities cannot be met as they fall due.

PIB Rules 2.6.2 and 2.7 clearly define the components of capital, with emphasis on those elements of capital used to absorb losses, and which are consistent with the requirements of Basel Capital Accord.

*Assessed as **Compliant***

**Principle 7: Risk management process**

*Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.*

Chapter 5 of the GEN module requires banks to establish and maintain risk management systems and controls to enable them to identify, assess, mitigate, control and monitor their risks. The rules also require banks to review their systems and controls on a regular basis.

GEN 5.2 requires appropriate oversight of the firm's activities by the governing body and the senior management. GEN Rule 5.2.1 requires the firms to apportion significant responsibilities among their senior management and maintain such appointments in such a way that their business and affairs can be adequately monitored and controlled by the governing body and the senior management.

The risk based supervisory approach of the DFSA is based upon establishing and operating a risk assessment framework which includes identifying, assessing, mitigating and controlling risks to the DFSA's objectives (Guidance 1.3 of SUP Module). As part of this the DFSA has adopted a continuous risk management cycle which comprises of periodic risk assessment visits as well as on-going interaction and monitoring of the firms. In the course of risk assessment visits and on-going monitoring, the supervisors aim to determine the key risks posed by the firm and to determine the appropriateness of the risk management framework employed by the firm given its size and complexity of operations. However, there are some areas of risk management where the DFSA is in the process of developing rules in conjunction with its introduction of the Basel 2 framework.

The DFSA will complete approximately 85 on-site risk assessments for 2007. On-site risk assessments are followed by implementation of risk mitigation plans with timely follow up for assessments that disclose matters requiring management attention or remedial action. We also conducted thematic reviews during 2007 of Authorised Firms and Ancillary Service Providers in relation to their implementation of Anti-Money Laundering and Counter-Terrorist Financing procedures and controls. This included confirmation of compliance with United Nations Security Council Resolutions 1737, 1747 and 1267. The results were communicated to authorised firms and are available on our website under "SEO (Senior Executive Officer) Letters".

*Assessed as **Largely compliant***

**Principle 8: Credit risk**

*Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.*

PIB Rule 4.2.2 (1) requires an Authorised Firm to develop, implement and maintain a Credit Risk policy that provides for sound, well developed risk management criteria that are to be applied when granting credit. PIB Rule 4.2.2 (2) requires a firm to ensure that its risk management systems enable it to implement the Credit Risk policy and identify, measure, monitor and control its Credit Risk. Firms are required to review and update their Credit Risk policy at intervals that are appropriate to the nature, scale and complexities of its activities (PIB Rule 4.2.2 (3)).

Section A4.2 of the Appendix 4 includes guidance on specific areas which the Credit Risk policy should cover. The DFSA views that this guidance adequately covers a sound and well documented credit granting process, maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting processes and ensuring adequate controls over credit risk.

As part of the periodic risk assessments completed so far, the supervisors have reviewed the credit risk management policies, procedures, processes, employed by banks. As part of the review, the supervisors have also ensured that the policies and procedures have been approved by the board or other appropriate authorities. The supervisors also assess whether the policies have been reviewed and the continued relevance of the risk management policies and tools, considering the growth in business levels, changing risk profile of the bank or banking group and external market developments. The supervisors also hold extensive discussions with the senior management and review credit risk reports, including credit approvals, exposure monitoring and data on loan quality to satisfy themselves that the senior management is implementing the overall credit risk strategy approved by the board in an effective manner.

However, due to the relatively low level of credit activity within banks that gets booked in DIFC entities, the DFSA has conducted a limited review of credit processes to date.

*Assessed as **Largely compliant***

**Principle 9: Problem assets, provisions and reserves**

*Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.*

PIB Rule 4.2.2 (d) requires firms to include, in their Credit Risk policy document, a provisioning policy approved by the firm's Governing Body or other appropriate body within the firm to which the firm's Governing Body has delegated this responsibility. Guidance in Appendix 4 of the PIB Rules sets out the specific aspects/areas that a firm should consider including in its Credit Risk policy document. These include risk measurement, risk monitoring, problem exposures, country risk exposure and provisioning aspects, which adequately cover the review of the individual credits, asset classification and provisioning.

In practice, supervisors have detailed discussions with the bank in respect of its credit and provisioning policies and as part of the assessment review the process by which individual credits are assessed and the loan classification process. The DFSA does not intend to set a prescriptive loan classification system: rather it relies on management at firms to produce a system that is adequate for the governance and mitigation of Credit Risks. The DFSA will employ credit specialists to review the credit identification, measurement and monitoring process in firms and benchmark practices between firms to determine the quality of the process at individual firms.

However, as at the date of completing this assessment the DFSA has not had extensive experience in implementing these procedures as there is very little Credit Risk being booked locally by banks authorised in the DIFC. The level of activity is increasing, however.

**Assessed as Largely compliant**

**Principle 10: Large exposure limits**

*Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.*

Rules 4.5.1 to 4.5.4 of the PIB Module of the DFSA Rulebook include prudential limits on large exposures to single or a group of Closely Related Counterparties. Large Exposure is defined in the GLO Module of DFSA Rulebook, in terms of percentage of capital resources. The rules generally limit a single or group exposure to 25% of the bank's capital base. The rules in A4.8 of PIB Module and the guidance in Rule 4.5.4 of PIB provide detailed guidelines on identification and measurement of exposures.

As part of the risk assessment process, the supervisors review and monitor the limits, adequacy of systems and controls to monitor the limits, reports on limit exceptions and subsequent handling or approval of such limit exceptions. Currently, the level of operations of the firms in the DIFC has not given rise to any material concentration risk related issues. However, due to the level of credit activity within banks, the DFSA is yet to build a solid operational experience of the review of review large exposure limits.

**Assessed as Largely compliant**

**Principle 11: Exposures to related parties**

*In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.*

PIB rule 4.2.2 read along with the definitions of the defined terms in the GLO module of the DFSA Rulebook provide a comprehensive definition of “related parties”. The rules prohibit exposures to Related Persons on terms that are more favourable than those available to persons who are not related persons.

PIB rule 4.2.2 (1) (e), requires banks to develop, implement and maintain a documented credit risk policy which, among other things, sets out explicitly the requirement to obtain prior approval of the board or the governing body of the firm, for any transactions or write-off of exposures made to related parties exceeding specified amounts or otherwise posing special risks. The proposed rules also require the credit risk policy to provide for adequate procedures for handling conflicts of interests relating to the provision of credit and sets out measures to prevent any Person directly or indirectly benefiting from the credit being part of the process of granting or managing the credit.

Consistent with the risk based supervisory approach; the DFSA’s supervisors view exposures to related parties as a high-risk area which receives close monitoring and review. Consequently, we review all related party transactions, bank’s policy on them, exposures arising out of related party transactions, appropriate approvals from the senior management or the board for any exceptions to policies or limits. Due to the low volume of such exposures to-date, there have been few opportunities to “operationalize” what we believe are robust requirements.

*Assessed as **Largely compliant***

**Principle 12: Country and transfer risks**

*Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.*

Appendix 4 of the PIB Rules provides guidance on the areas that a firm should cover in its Credit Risk policy document, including matters to be considered if the firm has large exposures in a particular country or region (Guidance A4.2.37). These explicitly cover the various aspects relating to the identification, monitoring and control of the country risk.

The supervisory approach of the DFSA includes an assessment of the specific risks within each bank. Based on the assessment, the DFSA prioritizes the risks and uses effective measures to monitor and mitigate them. Therefore, if country risk is identified as one of the key risks in the risk assessment process of a firm the supervisory approach of the DFSA expects to verify the effectiveness of the systems and controls designed to address them. However, currently, there is not sufficient experience in implementing this supervisory practice as the firms have not assumed significant levels of country or transfer risks.

*Assessed as **Largely compliant***

**Principle 13: Market risks**

*Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.*

GEN Rule 5.3 requires firms to establish and maintain systems and controls including risk management, compliance, internal audit, business plan and strategy, and management information systems to ensure that its affairs are managed effectively and responsibly by its senior management and undertake regular reviews of its systems and controls.

PIB Rule 5.2 contains a specific requirement for the firms to implement and maintain a Market Risk policy enabling it to identify, assess, control and monitor Market Risk. The rule expects the firm to document and include in its Market Risk policy document its risk appetite and how it identifies, assesses, mitigates, controls and monitors that risk. Authorised Firms must also review and update such policies at intervals that are appropriate to the nature, scale and complexities of its activities.

Though the supervisory approach of the DFSA intends and provides enough tools to determine that firms have suitable policies and procedures to effectively address the Market Risk, at the time of this assessment there are no firms in the DIFC with significant activities relating to their trading book. We anticipate this will change in the near term as several firms have or are moving trading operations into the DIFC, which will provide an opportunity to evidence supervisory implementation of this principle.

***Assessed as Largely compliant***

**Principle 14: Liquidity risk**

*Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.*

Chapter 6 of the PIB Rules comprehensively set out various requirements and guidance relating to the Liquidity Risk management. PIB Rule 6.2.4 requires firms to consider the effect of the off-balance sheet activities in identifying/assessing their Liquidity Risk. Guidance to this rule expects firms to consider the effects of various factors on their funding requirement including those from the commitments and standby facilities given by the firm. PIB Rule A6.2 and A6.3 set out criteria/conditions for including various assets (including marketable assets) and liabilities in the time bands for calculating the mismatch. These rules provide for allowing only truly liquid assets to be treated as such.

The rules under section 6.2 of the PIB module specify the requirements for systems and controls for managing liquidity risk. PIB rule 6.2.1 (2) requires the documented liquidity risk policy of the firm to include the strategy for the daily and long-term management of Liquidity Risk appropriate to the nature, scale and complexity of the activities of the firm.

PIB rule 6.2.2 requires the Governing Body of an AF to be responsible for monitoring the nature and level of liquidity risk assumed by the firm and the process used to manage that risk. The responsibilities of the Governing Body in respect of liquidity risk include approving the AF's liquidity risk strategy, establishing and maintaining a senior management structure for the management of liquidity risk and for ensuring compliance with the firm's risk strategy, monitoring the firm's overall liquidity risk profile on a regular basis and ensuring that liquidity risk is adequately controlled.

PIB rule 6.2.10 prescribes the requirement for the firms to have contingency plans in place for handling liquidity problems, including informing the regulators of liquidity issues.

At the licensing stage and as part of the supervisory relationship, the DFSA constantly reviews and evaluates aspects of a bank's liquidity risk management strategy, policies, processes and tools.

As part of the periodic risk assessments completed so far, the supervisors have reviewed the liquidity risk management policies, procedures, processes, employed by the firm. As part of the review, the supervisors have also ensured that the policies and procedures have been approved by the board or other appropriate authorities. The supervisors also hold extensive discussions with the senior management and review reports on liquidity risk, including exception reports, escalation of limit violations to satisfy themselves that the senior management is implementing the overall credit risk strategy approved by the board in an effective manner. However, the banks authorised by the DFSA have not yet built up significant short-term liability positions of their own and have limited exposure to asset-liability mismatch. Since most of them are branches, they rely on the head office for liquidity risk management.

***Assessed as Largely compliant***

**Principle 15: Operational risk**

*Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.*

GEN Rule 5.3.4 requires the Authorised Firms to establish and maintain risk management systems and controls to enable them to identify, assess, mitigate, control and monitor all their risks. Firms are expected to review their systems and controls on a regular basis.

GEN Rule 5.3.5 requires banks to develop, implement and maintain policies and procedures to manage the risks to which the AF, and where applicable its customers, are exposed.

The DFSA is currently in the process of developing exclusive rules as part of PIB module of its Rulebook specifying the requirements for authorised firms to implement and maintain systems and controls as well as to specify capital requirements for operational risk.

In the course of risk assessments completed so far, the supervisors have reviewed and ensured the continued relevance of the authorised firm's operational risk management policies and systems, given the changes in the firm's business and its growth.

*Assessed as **Largely compliant***

**Principle 16: Interest rate risk in the banking book**

*Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.*

DFSA's regulatory framework requires Authorised Firms to establish a robust systems and controls environment. GEN Rule 5.3 requires firms to establish and maintain systems and controls including risk management, compliance, internal audit, a business plan and strategy, as well as management information systems to ensure that its affairs are managed effectively and responsibly by its senior management. In addition, a firm must undertake regular reviews of its systems and controls.

GEN Rule 5.3.1 requires firms to establish and maintain systems and controls that ensure that its affairs are managed effectively and responsibly by its senior management. GEN Rule 5.3.4 requires an Authorised Firm to establish and maintain risk management systems and controls to enable it to identify, assess, mitigate, control and monitor its risks. GEN Rule 5.3.17 requires a firm to establish and maintain arrangements to provide its Governing Body and senior management with the information necessary to organise and control its activities, to comply with legislation applicable in the DIFC and to manage risks.

Banks currently operating in the DIFC have fairly simple asset and liability structures with no funding from retail deposits. Consequently, the supervisors have not had significant opportunity to review and determine the adequacy of the risk management framework for interest rate risk in the banking book.

Whilst the DFSA's regulatory framework includes the requirements for establishing and maintaining the overall risk management approach, it does not include specific requirements to address interest rate risk in the banking book.

*Assessed as **Materially non-compliant.***

**Principle 17: Internal control and audit**

*Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.*

Rules in the GEN module prescribe the responsibilities of the Governing Body and the senior management when overseeing the activities of an Authorised Firm. GEN Rule 5.2 requires the firm to apportion significant responsibilities among its senior management in such a way that the business and affairs can be adequately monitored and controlled by its Governing Body and senior management.

GEN Rule 5.3.1 requires firms to establish and maintain systems and controls that ensure that its affairs are managed effectively and responsibly by its senior management. Firms are also required to undertake regular reviews of its systems and controls. The nature and extent of the systems and controls of a firm will depend upon a variety of factors including the nature, size and complexity of its business (Guidance to GEN Rule 5.3.1).

GEN Rule 5.3.2 requires firms to implement clear reporting lines and management responsibilities that take into account the nature, scale and complexity of its business.

GEN Rule 5.3.3 requires firms to ensure that key duties and functions are segregated so as to avoid a situation where the allocation of duties and functions to be performed by the same individual could result in undetected errors or be vulnerable to abuse and thus expose the firm, its customers or users to inappropriate risks.

Safeguarding of assets and investments is the subject of an entire section in the Conduct of Business Rules particularly in respect of segregated assets. Chapter 9 of the COB Rules deals in detail with safeguarding client's assets and investments.

GEN Rules 5.3.13 to 5.3.15 specify both the need for, and requirements relating to, the internal audit function within a firm. An Authorised Firm is required to establish and maintain an internal audit function with responsibility for monitoring the appropriateness and effectiveness of its systems and controls. The internal audit function must be independent from operational and business functions.

The risk based supervisory approach of the DFSA is based upon establishing and operating a risk assessment framework which includes identifying, assessing, mitigating and controlling risks to the DFSA's objectives (Guidance 1.3 of SUP Module). As part of this the DFSA will adopt a continuous risk management cycle which will comprise the identification, assessment, prioritisation, and mitigation of risks arising from a range of areas within a firm, including business, operations, internal controls and compliance arrangements (Guidance 1.6.4 of SUP Module).

The risk assessment process, as outlined above, includes assessing the quality of internal control processes and the strength of systems and controls (i.e. policies, procedures and practices), established and maintained by the firms. Further, the DFSA has wide range of supervisory tools (detailed in guidance 1.7 of the SUP Module) such as on-site visits, high level meeting, desk based reviews, independent expert reports etc which could be used effectively in assessing the quality of the risk management systems of a firm.

*Assessed as **Compliant***

**Principle 18: Abuse of financial services**

*Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.*

The regulatory objectives of the DFSA include fostering and maintaining a fair, transparent and efficient financial services industry. Therefore, emphasis is placed on promoting high ethical and professional standards within Authorised Firms in the DIFC. This is reflected in various requirements for Authorised Firms set out in the relevant DIFC laws and related Rules and regulations. GEN Rule 4.2 specifies 10 principles applicable to the firms in the DIFC covering various aspects such as integrity, systems and controls, conduct of business etc. Principle 1 of this Rule requires firms to observe high standards of integrity and fair dealing. Furthermore, a need for high ethical and professional standards is also reflected in the Conduct of Business Rules of the DFSA Rulebook. With respect to the anti money laundering procedures, AML Rule 3.1.1 requires firms to establish and maintain effective policies, procedures and systems and controls to prevent opportunities for money laundering, in relation to the firm and its activities.

Rule 7.4 of the GEN Module specifies the requirements for firms to notify the DFSA in the event of the occurrence of any fraud, or if they suspect any fraudulent activity. The rules in the AML Module set out the requirement for the reporting of suspected money laundering activities to the appropriate authorities.

In June 2005, the DFSA carried out a theme review focusing mainly on various aspects of the suspicious transactions reporting, including the arrangements established by the firms with respect to the internal suspicious transactions reporting. In addition, anti-money laundering checks form a core part of both the Authorisation and the Supervision process. As mentioned under Principle 7, thematic reviews have also been conducted to ensure processes and practices are in place to prevent firms from being used by third parties to advance criminal activities.

*Assessed as **Compliant***

**Principle 19: Supervisory approach**

*An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.*

The Supervision Module of the DFSA Rulebook sets out the DFSA's general approach to supervision and in particular, in Section 1.6, the DFSA's approach to risk based supervision. The risk based approach involves the supervisor assessing Authorised Firms Licensed to conduct Banking Business (banks) against a range of business and control risks and determining a risk rating which drives the supervisory tools to be used including both on and off site tools.

All banks are required to submit quarterly reporting statements as set out in the DFSA Rulebook PIB, Chapter 7. This information is subsequently used by supervisors to analyse the financial conditions of the banks in addition to the statutory accounts and other information.

The DFSA has implemented a comprehensive risk assessment framework which is used as the primary tool for the periodic risk assessment visits as well as for assessing the incremental impact of any events with regulatory impact. This risk assessment framework considers all the risks posed by a firm to the DFSA's objectives in a methodical fashion. The framework covers risks from business and operations, adequacy of internal controls and compliance arrangements.

The supervisors at the DFSA use both the on-site and off-site tools to confirm authorised firm's compliance with prudential regulations and legal requirements.

The supervisors review the quarterly and annual prudential returns submitted by the firms to confirm compliance with prudential rules. The supervisors also review the annual reporting requirements regarding money laundering and controllers as well as supervisory notifications as defined in the SUP module to confirm firm's compliance with the rules, regulations and laws of the DFSA.

As part of the risk assessment visits and other theme visits, the supervisors look for evidence on a systematic basis to confirm compliance with the rules and regulations. This has been an integral component of every risk assessment completed by the DFSA's supervisors. Quarterly returns are used to check balance sheet and profit and loss trends in addition to capital adequacy indicators and other gearing and financial ratios.

GEN Chapter 8 requires auditors to report on the financial condition of Authorised Firms including confirming that regulatory returns comply with PIB rules. This is in addition to the standard audit report required under the rules of the IAASB.

*Assessed as **Compliant***

**Principle 20: Supervisory techniques**

*An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.*

The DFSA recognises as part of its risk assessment framework the relative expense of exclusively using onsite tools. Hence, it uses a balance of on and offsite regulatory tools to maximise regulatory efficiency. The tools for verifying the financial condition of banks have been described in Principle 19. The relative mix of on-site and off-site supervisory efforts for different firms will depend on the supervisor's assessment of the risks faced by the firm.

The quality, effectiveness and integration of on-site and off-site supervisory processes and related efforts are subject to review and assessment by way of a peer review of the work carried out by a firm's supervisor and additionally by the review exercised by the Supervision Advisory Committee.

Quality of management is an explicit factor considered by supervisors as part of both the Licensing process and ongoing supervision. AUT Rule 3.3.1(c) notes that the DFSA would hold an applicant for authorisation to be fit and proper only if "the applicants affairs will be conducted and managed in a sound and prudent manner." The Licensing process also requires every firm to appoint a UAE resident SEO who is required to satisfy DFSA on fitness and propriety criteria. This is further explained in Appendix 1 of AUT which details the kinds of issues that firms will have to demonstrate to ensure that senior management are fit and proper.

As part of the risk assessment process, supervisors are explicitly required to review the quality of management as part of the risk category "internal controls and compliance arrangements", and the risk group "management and governance risks."

*Assessed as **Largely compliant***

**Principle 21: Supervisory reporting**

*Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.*

Section 1.5 and Appendix 7 of the PIB Module detail the prudential returns that all Authorised Firms are required to submit to the DFSA, and the frequency of their reporting. DIFC incorporated banks are required to submit on a solo and consolidated basis a balance sheet, profit and loss account, capital adequacy and large exposures schedule and a liquidity return at least once a quarter. The information covers both on and off balance sheet exposures. The prudential returns required to be filed by domestic firms provide information on profitability, capital adequacy, liquidity (wherever applicable) and, concentration risk.

In addition, the DFSA is in the process of establishing a comprehensive data collection and dissemination system for collecting and analysing prudential information submitted as part of the prudential returns by the firms. The project will be implemented with the 31 December 2007 reporting period, and will enable the DFSA to store and analyse prudential information, calculate financial ratios and monitor trends across periods. The system will produce firm-specific reports detailing the financial position, performance indicators, capital adequacy positions and key ratios, enabling the supervisors to identify areas requiring increased level of attention.

Chapter 8 of the GEN Module outlines the key duties and responsibilities of auditors of Authorised Firms. In particular, Section 8.6 of GEN 8 requires auditors to produce an auditor's annual report which, among other things, requires an opinion that regulatory returns of Authorised Firms (including capital adequacy returns) have been properly prepared as at the date of the firms' year end. The auditor's annual report referred above,

The supervisors receive and review the annual report from auditors, submitted to fulfil the requirement under GEN rule 8.6.1 (c), to confirm that the auditors have expressed an opinion on the proper preparation of the prudential returns. In addition, the review of returns by the supervisors as soon as the returns are received often includes plausibility checks and request for further information to confirm the integrity of data.

**Assessed as Compliant**

**Principle 22: Accounting and disclosure**

*Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.*

The GEN Module in Chapter 8 requires all Authorised Firms to maintain and prepare accounting records in accordance with International Financial Reporting Standards, (IFRS). In addition, within the PIB Module explicit reference is made to positions that are held on the trading and non trading books and the need to ensure that they are marked to market on an appropriate and timely basis. The need to make appropriate provisions and report profits net of provisions is set out in the guidance to Appendix A4 of the PIB Module.

GEN Module Chapter 8, requires auditors to meet the standards set by the International Auditing and Assurance Standards Board, (IAASB), and DFSA considers that those detailed standards cover the requirement set out in this additional criteria. The DFSA conducts a periodic review of the quality of an auditor's work both at the point where the auditor is seeking admission onto a register of auditors maintained by the DFSA, and then on an ongoing basis assesses the continued fitness and propriety of auditors.

GEN Rule 8.6.3 requires all Authorised Firms to make their audited annual accounting statements available to members of the public at a reasonable cost. These accounting statements themselves must be in compliance with the IFRS which imposes certain disclosure requirements which in effect aids market discipline.

**Assessed as Compliant**

**Principle 23: Corrective and remedial powers of supervisors**

*Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.*

As per the provisions of the Regulatory Law, the DFSA is empowered to decide and to take appropriate action to achieve orderly resolution of a problem bank situation. Under these powers, the DFSA may:

- Commence administrative proceedings before the Financial Markets Tribunal relating to a licence, authorization or registration. This may include imposing conditions on a licence, withdrawing authorisation or registration, or suspending an Authorised Individual;
- appoint managers, accept and enforce undertakings, impose fines, issue administrative censures;
- apply to the DIFC Court for injunctions, freeze orders, compliance and restraining orders and orders for receivers, trustees and compulsory winding up,
- intervene in any civil proceedings where the DFSA considers it is appropriate to meet the DFSA's objectives; and
- where there may be evidence of criminal activity, refer the matter to the appropriate authorities in the UAE responsible for enforcing the UAE Penal Laws; and
- obtain enforceable undertakings by agreement to ensure compliance with certain concerns that the regulator may have (see Article 89 of the Regulatory Law).

In addition, the DFSA also has a range of supervisory actions and measures to employ when a firm fails to comply with the laws, rules and regulations of the DFSA or when a firm engages in unsound practices threatening the stability of the DIFC markets. These supervisory actions include the ability to require a bank to take prompt remedial action and to impose penalties. Consistent with its risk-based supervisory approach, the tools employed by the DFSA to deal with any specific situation or firm will be proportionate to the risks or threats posed by that situation or firm.

*Assessed as **Compliant***

**Principle 24: Consolidated supervision**

*An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.*

Chapter 1 and Section 1.5 of the Supervision Module sets out DFSA's approach to "Group Supervision." Prior to authorising a bank, the DFSA considers the relationship of the bank with the wider Group. The DFSA will also take into account any lead or consolidated supervision to which the firm is subject. It is made clear that any information may be requested from a firm including prudential and systems and controls reports of the wider Group.

Section 1.5 also notes that a domestic firm with a head office in the DIFC will be regulated on a consolidated basis by the DFSA. The DFSA will prudentially supervise a subsidiary of a non DIFC headquartered firm, and will look to the lead or overseas supervisor to satisfy consolidated supervisory arrangements. The actual techniques for quantitative consolidated supervision are set out in the PIB module, Chapter 7.

However, due to the context of the Centre and the types of Authorised Firms, the DFSA has not had extensive opportunity to supervise banks on a consolidated basis, although it has the power to do so.

*Assessed as **Largely compliant***

**Principle 25: Home-host relationships**

*Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.*

Wherever appropriate, the DFSA enters into a Memorandum of Understanding (MOU) or other agreement setting out its relationship with the overseas supervisor. A number of MOUs have been concluded and many more are in the process of being concluded. A typical section of the MOU requires an obligation on both sets of regulators to inform each other in the event of any adverse assessment of the qualitative aspects of a bank's operations. DFSA's general policy is to share information as much as possible and be as open as is legally permissible with other supervisors who are obliged to keep confidential regulatory information confidential to the same extent as the DFSA, i.e. international regulatory standards.

DFSA has express legislative powers to share information with foreign regulatory counterparts. It has also expressed its willingness openly to share information with home country supervisors of internationally active firms with operations in the DIFC to enable more coordinated and effective supervision. This has also occurred in practice. The DFSA has been included in a "College of Supervisors" with other home-host supervisors with respect to an internationally-active firm's Basel II compliance. There have been regular information exchanges and dialogue with regulators and supervisors in other jurisdictions.

There is a distinction between the prudential supervision of foreign bank branches within and banks that are incorporated in the DIFC due to the DFSA's insolvency regime, which does not permit the ring fencing of assets of a branch in the event of the insolvency of the parent. Consequently, in authorising a branch, DFSA is authorising the "whole" bank and waiving the application of rules relating to the financial resources and capital requirements for the branch. The waiver is only granted provided the home state regulator prudentially supervises the whole bank including the branch to a level equivalent to that of the DFSA, and the prudential capital adequacy rules employed by the home regulator is equivalent to those prescribed in the PIB module of the Rulebook. The assessment of this core principle has been made, bearing in mind, the nature and complexity of the banking industry in the DIFC as of now and the fact that the DFSA is equipped to meet the requirements outlined in the criteria underlying this core principle.

*Assessed as **Compliant***