DOMESTIC SYSTEMICALLY IMPORTANT BANKS MODULE

MODULE	DS Domestic Systemically Important Banks
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DS-A.1 Purpose

Executive Summary

DS-A.1.1 The Domestic Systemically Important Banks (D-SIBs) Module sets out the Central Bank of Bahrain's ('CBB's) framework applicable to <u>Bahraini conventional bank licensees</u> identified as D-SIBs. This module provides guidance on the CBB's assessment methodology for identifying D-SIBs, and the Higher Loss Absorbency ('HLA') capital requirements to which such banks will be subject. The Module also sets out the supervisory measures and requirements to be applied by banks identified as being systemically important. This requirement is supported by Article 44(c) of the Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law') (Decree No. 64 of 2006).

DS-A.1.2 This Module shall be read in conjunction with other parts of the Rulebook, mainly:
(a) Principles of Business;
(b) High-level Controls;
(c) Capital Adequacy;
(d) Stress Testing; and
(e) Internal Capital Adequacy Assessment Process ('ICAAP').

Legal Basis

DS-A.1.3 **This Module contains the CBB's Directive relating to D-SIBs and is issued under the powers available to the CBB under Article 38 of the CBB Law. The Directive in this Module is applicable to all <u>Bahraini conventional bank licensees</u>.**

DS-A.1.4 For an explanation of the CBB's rule-making powers and different regulatory instruments, see Section UG-1.1.

DS-A.2 Module History

Evolution of the Module

DS-A.2.1 This Module is first issued in July 2018 as part of Volume One of the CBB Rulebook. The requirements in this Module are effective from the date of issuance. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made. Chapter UG-3 provides further details on Rulebook maintenance and version control.

DS-A.2.1 The most recent changes made to this Module are detailed in the table below:

Summary of Changes

Module Ref.	Change Date	Description of Changes

DS-1.1 Overview

DS-1.1.1 The objective of the D-SIBs framework is to identify banks that could cause significant disruption to the domestic financial system and economic activity locally in the event of distress or failure. To address the negative externalities posed by such banks, regulatory and supervisory measures will be undertaken with the aim of:

(a) Reducing the probability of failure of D-SIBs, by increasing their going-concern loss absorbency through additional capital requirements, requiring early recovery planning and increasing the intensity of their supervision; and
(b) Reducing the extent or impact of any failure, by improving the resolvability of these banks.

DS-1.2 General Requirements

DS-1.2.1 **Bahraini conventional bank licensees designated as D-SIBs must hold designated HLA expressed as Common Equity Tier 1 ('CET1') capital at 1.5 percent of the total Risk-Weighted Assets ('RWA'), as calculated for the purposes of capital adequacy.**

DS-1.2.2 **The HLA requirement must be fully met by the CET1 capital. This is to ensure that the capital held for HLA purposes must be available to absorb losses on a going-concern basis and, as such, enhance the resilience of the relevant D-SIB.**

DS-1.2.3 **Bahraini conventional bank licensees designated as D-SIBs will be subject to an annual inspection by the CBB and two prudential meetings per year.**

DS-1.2.4 The HLA requirement and the Pillar 2 capital add-on address the external and internal risks associated with banks from different, but complementary perspectives.

Disclosure Requirement for D-SIBs

DS-1.2.5 **Bahraini conventional bank licensees designated as D-SIBs must disclose their D-SIB HLA requirement in their capital disclosures for the purpose of disclosures of the composition of the bank's capital base.**

Recovery and Resolution Plans

DS-1.2.6 **Bahraini conventional bank licensees designated as D-SIBs must develop and maintain Recovery and Resolution Plans (RRPs) specific to their circumstances and reflect the nature, complexity, interconnectedness, level of substitutability and size of the bank in question. The RRPs must be approved by the CBB.**

DS-1.3 D-SIBs Assessment Framework

DS-1.3.1 The D-SIBs Assessment Framework aims to assess the degree to which banks are systemically important to the local financial system and domestic economy. Accordingly, the assessment focuses on the impact of a bank's failure within the financial system.

DS-1.3.2 D-SIBs are identified using a two-step approach. The first step is to draw up a preliminary indicative list of D-SIBs based on the quantitative scores calculated using a set of factors/indicators. The second step involves the exercise of supervisory judgment that may serve as a complement to the quantitative assessment process, i.e. to refine the preliminary indicative list by either (i) removing banks from the list; or (ii) including other banks onto the list.

DS-1.3.3 The D-SIBs assessment is based on the following four factors:

(a) Size

i. Size is a key measure of systemic importance. The larger the bank, the more widespread the effect of a sudden withdrawal of its services and, therefore, the greater the chance that its distress or failure would cause disruption to the financial markets and systems in which it operates, and to the broader functioning of the economy. The size factor broadly measures the volume of a D-SIB's banking activities within the local banking system and economy and, therefore, provides a good measure of the potential systemic impact in case a bank should fail.

ii. The quantitative indicator used in the D-SIBs framework to measure a bank's size is its total assets, as disclosed in the balance sheet.

(b) Interconnectedness

i. This measure captures the extent of a bank's interconnections with other financial institutions, which could give rise to externalities affecting the financial system and domestic economy.

ii. The quantitative indicators used to capture interconnectedness are interbank activities (represented by intra-financial system assets, and intra-financial system liabilities) and securities outstanding.

iii. Intra-financial system assets comprise lending to financial institutions (including undrawn committed lines), holding of securities issued by other financial institutions, gross positive current exposure of Securities Financing Transactions and exposure value of those Over the Counter ('OTC') derivatives which have positive current market value. Intra-financial system liabilities comprise deposits by other financial institutions (including undrawn committed lines), gross negative current exposure of Securities Financing Transactions and exposure value of those OTC derivatives which have negative current market value. The total marketable securities issued by the bank comprise debt securities, commercial paper, certificate of deposit and equity issued by the bank. The total marketable securities issued by the bank with the data on maturity structure of these securities will give an indication of the reliance of the bank on wholesale funding markets.

DS-1.3 D-SIB Assessment Framework (Continued)

(c) Substitutability

i. The concept underlying substitutability as a factor for assessing systemic importance, is the recognition that the greater the role of a bank in a particular business line, or in acting as a service provider in relation to market infrastructure, the more difficult it will be to swiftly replace that bank and the extent of the products and services it offers, and, therefore, the more significant the risk of disruption in the event that the bank becomes distressed.

ii. The quantitative indicators used to capture substitutability are assets under custody (i.e. the value of assets that a bank holds as a custodian), payment activity (i.e. the value of a bank's payments sent through all of the main payments systems of which it is a member) and values of underwritten transactions in debt and equity markets (i.e. the annual value of debt and equity instruments underwritten by the bank). This is based on the logic that the higher the market share of a bank, the more difficult it will be to substitute the extent and level of service it provides.

(d) Complexity

i. The degree of complexity of a bank is generally expected to be proportionately related to the systemic impact of the bank's distress, as the less complex a bank is, the more 'resolvable' it will likely be, and, in turn, the more likely the impact of its failure could be contained.

ii. The quantitative indicators used to capture complexity are the notional value of OTC derivatives (i.e. the ratio of the notional amount outstanding for the bank), Level 3 assets and ratio of the total value of the bank's holding of securities for trading and available for sale category.

Qualitative Indicators

DS-1.3.4 The CBB will apply a supervisory judgmental overlay to the quantitative assessment process recognising that some of the most effective indicators for assessing systemic importance tend not to be of a quantitative nature and, as such, not captured by a quantitative indicator-based measurement approach.

DS-1.3.5 The CBB's indicative list of qualitative indicators that will typically be considered are:

(a) Anticipated business expansion/contraction;
(b) Anticipated mergers and acquisitions;
(c) Analysis of exposures to a particular banking group;
(d) Settlement institution for any payment or clearing system;
(e) Extent of retail banking network;
(f) Number of local and overseas branches;
(g) Analysis of non-banking business exposure and income;
(h) Analysis of non-plain vanilla products/portfolios held;
(i) Analysis of off-balance sheet exposures;
(j) Complexity of the group structure; and
(k) Reputational risk.

DS-1.3 D-SIB Assessment Framework (Continued)

Assessment Approach

DS-1.3.6 A weight is assigned to each of the 'size', 'interconnectedness', 'substitutability' and 'complexity' factors. The CBB applies 25 percent equally to all factors towards the final aggregate score.

Category (and weighting)	Individual indicator	Indicator weighting
Size	Total assets	25%
Interconnectedness	Intra-financial system assets	8.33%
	Intra-financial system liabilities	8.33%
	Securities outstanding	8.33%
Substitutability	Assets under custody	8.33%
	Payments activity	8.33%
	Underwritten transactions in debt and equity markets	8.33%
Complexity	OTC derivative notional value	8.33%
	Level 3 assets	8.33%
	Trading and available-for-sale securities	8.33%

DS-1.3.7 Bahraini conventional bank licensees that have a minimal amount of exposure to clients in Bahrain, and a low percentage of their deposits base are from clients in Bahrain, will be excluded from the D-SIB assessment.

DS-1.3.8 The CBB shall conduct the D-SIB assessment every two years and shall inform the banks, the relevant thresholds or cut off, and shall provide the DSIBs the guidance for implementation.

DS-2.1 Recovery and Resolution Plans

DS-2.1.1

Recovery and Resolution Plans (RRPs) developed by DSIBs must be specific to their circumstances reflecting the nature, complexity, interconnectedness, level of substitutability and size of the bank in question. RRPs must include:

(a) High-level substantive summary of the key recovery and resolution strategies and an operational plan for implementation;
(b) Strategic analysis that underlies the recovery and resolution strategies;
(c) Conditions for intervention, describing necessary and sufficient prerequisites for triggering the implementation of recovery or resolution actions;
(d) Concrete and practical options for recovery and resolution measures;
(e) Preparatory actions to ensure that the measures can be implemented effectively and in a timely manner;
(f) Details of any potential material impediments (legal, strategic or technical) to an effective and timely execution of the plans; and
(g) Responsibilities for executing preparatory actions, triggering the implementation of the plans and the actual measures.

DS-2.1.2

Bahraini conventional bank licensees must engage in an annual simulation and scenario exercise to assess whether the RRPs are feasible and credible. The Board must approve any changes to RRPs resulting from such exercise. The results of such annual exercise and changes required to the RRPs, if any, must be reported to the CBB by the end of 4 months from financial year end.

DS-2.1.3

Underlying assumptions of the RRPs and stress scenarios must be sufficiently severe, but plausible. Both "solo" specific and "consolidated" stress scenarios, as appropriate, must be considered taking into account the potential impact of cross-border contagion in crisis scenarios, as well as simultaneous stress situations in several significant markets. RRPs must not make the assumption that the CBB or government support can be relied upon to recover the bank.

DS-2.1.4

Bahraini conventional bank licensees must develop a robust governance structure and sufficient resources to support the recovery and resolution planning process. This includes clear responsibilities of business units, senior management up to, and including, board members. A senior level executive must be made responsible for the overall RRPs. This person must be responsible for ensuring that the bank is, and remains in compliance with the requirements of the RRPs and for ensuring that recovery and resolution planning is integrated into the bank's overall governance processes.

DS-2.1 Recovery and Resolution Plans (Continued)

DS-2.1.5

Bahraini conventional bank licensees must have systems in place that are able to generate on a timely basis, the information required to support the recovery and resolution planning process to enable both the bank and the CBB to carry out recovery and resolution planning effectively, and, where necessary, implement the RRPs.

DS-2.1.6

RRPs should serve as guidance to banks and the CBB in a recovery or resolution scenario. The CBB may implement a different strategy should the bank need to be resolved.

Recovery Plan

DS-2.1.7

The Recovery Plan must identify possible recovery measures, recovery options and the necessary steps and time needed to implement such measures, as well as assess the associated risks. An effective Recovery Plan must at least consider the following:

(a) Governance arrangements and escalation process following a trigger event;

(b) Recovery triggers must be well-defined and tailored to the full range of risks faced by the bank. The threshold level for triggers must be calibrated with impact on the bank's economic capital and set out clearly in the bank's recovery plan;

(c) Actions or responses that should occur when triggers are breached; there should be an expectation that breach of a trigger causes a predetermined escalation and information process up to Board and Senior Management level;

(d) A detailed explanation and analysis, illustrating how the triggers were calibrated, as well as highlighting the effectiveness of the triggers;

(e) Incorporating qualitative triggers in their consideration of whether a recovery response is necessary and, if so, what kind of response would be appropriate;

(f) Incorporating the triggers for recovery planning into the bank's overall risk management framework. Recovery triggers must be aligned with (but not limited to) existing triggers for liquidity or capital contingency plans, early warning indicators and the bank's risk appetite;

DS-2.1 Recovery and Resolution Plans (Continued)

(g) Triggers for recovery planning must be complemented by early warning indicators that alert the bank to emerging signs of stress, but that do not yet give rise to a triggering event;

(h) Use at least one market-wide (systemic) stress scenarios and one bank-specific (idiosyncratic) stress scenarios, as well as a combination of systemic and idiosyncratic stress scenarios, to assess the robustness of their Recovery Plans and to assess which recovery options would be effective in a range of stress situations; and

(i) Allocation of losses to shareholders, and unsecured and uninsured creditors in a manner that respects the hierarchy of claims.

DS-2.1.8

Bahraini conventional bank licensees must notify the CBB when high levels of stress are experienced and/or recovery plan triggers are breached. Banks must also notify the CBB on the Recovery Plan actions or responses that would be taken by the Bank when the plan is activated.

DS-2.1.9

Bahraini conventional bank licensees must use quantitative and, if relevant, qualitative triggers in their recovery plans. The quantitative triggers focused on firm-specific liquidity and capital measures are critical. The quantitative triggers may include different elements such as:

(a) withdrawal of deposits and other funding;
(b) revenue performance (or components of these);
(c) ratings downgrades;
(d) credit risk limits;
(e) equity ratios;
(f) renewal of wholesale financing;
(g) increased collateral requirements;
(h) interest rate environment; and
(i) senior debt spreads.

DS-2.1.10

Bahraini conventional bank licensees must use three stress scenarios at a minimum, i.e. systemic, idiosyncratic and a combination of both for the purpose of recovery planning.

DS-2.1 Recovery and Resolution Plans (Continued)

DS-2.1.11 The following elements are illustrative in nature for stress scenarios to be considered in Recovery planning:

a) significant deposit withdrawal or runoff;
b) collapse of global financial markets;
c) significant capital and liquidity impacts;
d) severe losses through a rogue trader;
e) rating downgrades;
f) US Dollar or a Euro crisis;
g) GDP growth rates;
h) loss of goodwill;
i) exodus of talent;
j) currency or commodity prices volatility;
k) increased collateral requirements;
l) bank failures;
m) fraud; and
n) reputational crisis.

DS-2.1.12 **Bahraini conventional bank licensees must consider a variety of feasible recovery options that could play a critical role towards improving resilience and viability ultimately. Such options may include for instance the following illustrative options:**

(a) Issuance of capital instruments at short notice;
(b) Seeking additional liquidity from existing or new sources;
(c) Sale or disposal of a part of the business and assets;
(d) Restricting new business activities;
(e) Lowering dividend pay outs; and
(f) Restructuring.

Resolution Plan

DS-2.1.13 **Bahraini conventional bank licensees must establish Resolution Plans intended to facilitate smooth resolution making it feasible without severe market disruption. It must include a substantive resolution strategy approved by the Board and agreed with the CBB, and an operational plan for its implementation. It must identify, in particular:**

(a) Financial and economic functions for which continuity during the resolution process is critical and suitable resolution options to preserve those functions, or wind them down in an orderly manner;
(b) Data requirements on the bank's business operations, structures, and systemically important functions;
(c) Potential legal, strategic or technical barriers to effective resolution and actions to mitigate those barriers; and

DS-2.1 Recovery and Resolution Plans (Continued)

(d) Actions to protect insured depositors and ensure the rapid return of segregated client assets.

DS-2.1.14 **Bahraini conventional bank licensees must consider the following important elements in their analysis leading to the development of the resolution plan:**

(a) The corporate and group structure
(b) Relevant entities and the identification of material entities;
(c) Balance sheet profile including on and off balance sheet;
(d) Funding, liquidity and capital needs;
(e) Business model of the parent and material entities;
(f) Core business lines;
(g) Operational, financial, legal and structural dependencies;
(h) External dependencies;
(i) Financial functions mapping each material entity and business lines;
(j) Resolution strategies and options.

DS-2.1.15 For the purpose of DS-2.1.13(a), banks shall consider in their recovery and resolution planning processes the identification and the development of suitable resolution options for 'critical functions' and 'critical shared services. The resolution strategy and operational plan should encompass appropriate actions which help maintain continuity of these functions while avoiding unnecessary loss of value and minimising, where possible, the costs of resolution.

DS-2.1.16 Critical functions are activities performed for third parties not affiliated to the bank, the failure of which would lead to a disruption of services that are vital for the functioning of the real economy and for financial stability due to the bank/banking group's size or market share, interconnectedness, complexity and cross-border activities.

DS-2.1.17 The designation of a function as critical does not imply that the function and all related liabilities will be protected in a resolution. Rather, the designation is meant to assist the CBB and relevant authorities in developing resolution strategies that minimise systemic disruption and preserve value. It is important to note that the institution specific lists of critical functions will be an important input in the resolution planning process and the resolvability assessments.

DS-2.1 Recovery and Resolution Plans (Continued)

DS-2.1.18 The criticality of a function can be assessed in a three-step process:-

a) **Impact assessment**: It will include understanding the nature and extent of the activity and assessing the impact of the failure of the function on the market and infrastructure, on customers, on other market participants and finally the interdependencies of the market;

b) **Evaluating the market for that function**: This will encompass understanding how quickly the market is able to substitute the service providers of the failed function. Such an assessment will include supply side analysis of service providers covering market concentration;

c) **Firm-specific test**: The analysis will determine whether the bank's failure would have a material impact on third parties, on the potential for contagion and on the general confidence of market participants which will be based on understanding of the overall market share of the firm for that specific function etc.

DS-2.1.19 These critical functions are assessed in the following five broad categories with distinct economic objectives and characteristics: (a) Deposit Taking, (b) lending and loan servicing; (c) payments, clearing custody and settlement, (d) lending and borrowing to and from financial institutions; and (e`) Capital markets and investment activities.

DS-2.1.20 Critical shared services are activities performed within the bank or by another unit within the group or outsourced to third parties and their failure would lead to the inability to perform critical functions and, therefore, to the disruption of functions vital for the functioning of the real economy or for financial stability.

DS-2.1.21 Critical shared services are related to the critical functions a bank performs. They provide the internal and essential infrastructure the bank needs to continue operating. Their designation should therefore follow from the identification of the critical functions. The prioritising of the critical shared services, starts with answering the following questions first:

a) How severe are the consequences of the failure of a particular service on one or more critical functions?

b) How quickly will the failure of a particular shared service lead to a collapse of one or more critical functions?

DS-2.1.22 For the purposes of this analysis, there should be a clear understanding of the following aspects of the shared services at legal entity level:

i. the provider and the recipient of the services;
ii. the nature of the services being provided;
iii. the financial terms on which those services are offered;
iv. the existence of service level agreements and the validity of such agreements in the event of failure; and
v. the impact of default on the ability of the bank to maintain these services.
vi. the substitutability of the services being provided (see above).

DS-2.1 Recovery and Resolution Plans (Continued)

DS-2.1.23 **Bahraini conventional bank licensees must ensure that key Service Level Agreements (SLAs) can be maintained in crisis situations and in resolution, and that the underlying contracts include provisions that prevent termination triggered by recovery or resolution events, and facilitate transfer of the contract to a bridge institution or a third party acquirer.**

DS-2.1.24 Nothing in this Module will preclude CBB from devising other resolution strategies, options or plans recognised under the CBB Law should it believe it is necessary under the circumstances.

DS-3.1 Independent Review

DS-3.1.1

Bahraini conventional bank licensees must ensure that the RRPs are subject to independent review by a third party consultant, other than the external auditor upon first implementation of the requirements in this Module, and subsequently, when there are material changes in the relevant Rulebook requirements or to the business conducted by the bank and/or its risk profile.

DS-3.1.2

In addition, such reviews must test compliance by banks with the requirements of this Module and ensure the coverage includes the following:

(a) Adequacy of management oversight and approval of the RRPs;
(b) Adequacy of documentation supporting the RRPs;
(c) Integration of ICAAP and stress testing into RRP process;
(d) Sufficiency of the trigger framework and the process for implementing and monitoring them;
(e) Escalation process and the integrity of the planned actions against the triggers;
(f) Authorisation for, and implementation of, significant changes to the RRPs;
(g) Alignment of the RRPs to the bank's business strategies, group and organisational structure;
(h) Due consideration of the legal and external environment;
(i) Verification of the quality of data sources used to run the stress tests (e.g. in terms of accuracy, consistency, timeliness, completeness and reliability).