



# **CREDIT RISK MANAGEMENT**

## **MODULE**



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<b>CHAPTER</b>	<b>CM-A:</b>	<b>Introduction</b>

## **CM-A.1 Purpose**

**CM-A.1.1** The purpose of this Module is to provide a checklist of the key elements of a sound credit risk management system which supervisors can expect their banks to observe. This requirement is supported by Article 44(c) of the Central Bank of Bahrain and Financial Institutions Law (Decree No. 64 of 2006).

**CM-A.1.2** This Module provides support for certain other parts of the Rulebook, mainly:

- (a) Principles of Business;
- (b) The CBB Reporting Requirements;
- (c) Audit Firms;
- (d) High-level Controls; and
- (e) Capital Adequacy.

### *Legal Basis*

**CM-A.1.3** This Module contains the CBB's Directive relating to the credit risk management of conventional bank licensees, 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 conventional bank licensees.

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



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## **CM-A.2 Key requirements**

**CM-A.2.1**

Branches of foreign banks in Bahrain are expected to maintain provisions against potential loan losses on their books in Bahrain. Head offices of banks that do not wish to maintain provisions on books of their branch(es) in Bahrain should advise the Central Bank, on an annual basis and in writing, of the amount of provisions set aside for the bad debts of Bahrain branch(es).

**CM-A.2.2**

The Central Bank requires all Bahraini conventional bank licensees to set out their policy on large exposures, including limits for differing types of exposures to individual customers, banks, corporates, countries and economic and market sectors, in a policy statement which should be formally approved by the Board of Directors.

**CM-A.2.3**

The aggregate of large exposures may not exceed 800% of the bank's (consolidated) capital base. A bank may not incur an exposure to an individual counterparty or group of closely related counterparties which exceeds 15% of the reporting bank's (consolidated) capital base.

**CM-A.2.4**

Exposures to all connected counterparties when taken together, may not exceed 40% of (consolidated) capital base. Shareholders with significant ownership of the bank's capital (10% and above) are not allowed to borrow from the bank (i.e. a 0% limit), however smaller shareholders will be subject to a 15% limit on an individual basis. Directors who are also shareholders with significant ownership are subject to the 0% limit.

**CM-A.2.5**

All locally incorporated Bahraini conventional bank licensees are required to report (for the attention of the Director of Banking Supervision Directorate) all large exposures, (whether exempt or not) on a quarterly basis using the Form PIR provided in Appendix BR-5.

**CM-A.2.6**

The Central Bank's prior written consent should be obtained for any loan to an employee where the amount of such loan, either singly or when added to an existing loan(s) outstanding to that employee at that date, would be equal to or in excess of BD 100,000 (or its equivalent).



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**CM-A.2.7**

Licensees may only provide a new consumer facility (or renew, extend or otherwise modify an existing consumer facility) for an amount such that the borrower's total monthly repayments on all his consumer finance commitments do not exceed 50% of his monthly gross income.

**CM-A.2.8**

Licensees must make clear to potential borrowers, prior to entering into a consumer finance agreement, all relevant key terms of the agreement. Licensees must also follow the provisions of the "Code of Best Practice on Consumer Credit and Charging" as agreed between the Bankers' Society of Bahrain and the CBB.

**CM-A.2.9**

The Central Bank's prior written consent should be obtained before writing off any loan to a senior employee/officer/Director of the reporting bank or other bank(s) who fails to discharge his/her repayment obligations to the reporting bank (see Section CM-7.1 for details).

**CM-A.2.10**

The bank should notify the Central Bank of any write-off of a credit facility, (i.e., loan, overdraft and any other credit facility) of an amount in excess of BD 100,000 (or its equivalent).

**CM-A.2.11**

All banks which provide credit to resident natural persons in Bahrain must become members of the Credit Reference Bureau and follow the CRB Code of Practice (see Appendix CM-3).

**CM-A.2.12**

All banks are required to follow the CBB's requirements concerning refund of insurance on loan prepayments and top-ups and early repayment fees/charges as outlined in Section CM-8.6.



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### **CM-A.3 Module History**

**CM-A.3.1** This Module was first issued in July 2004 as part of the conventional principles volume. 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.

**CM-A.3.2** The most recent changes made to this Module are detailed in the table below:

#### *Summary of changes*

Module Ref.	Change Date	Description of Changes
CM 8	1/1/2005	Revised Consumer Finance Limits
CMA-2	1/1/2005	Revised Key Requirements to reflect CM 8 above
CM 8.3	1/7/2005	Revised definition of 'consumer loan'
CM 3.2	1/10/2005	Role of internal audit becomes a rule
CM 8.4	1/10/2005	Clarifications re non-compliant facilities
CM-A.1	10/2007	New Rule CM-A.1.3 introduced, categorising this Module as a Directive.
CM-8	10/2007	New Requirement to follow the "Code of Best practice on Consumer Credit and Charging".
CM-1.2	10/2007	Membership of CRB
CM-7.1	04/2008	Guidance concerning material interest as shareholder for write-offs
CM-8.6	04/2008	New Refund and prepayment requirements
CM-5.7	10/2009	New reporting arrangements for exposures of connected counterparties.
CM-5.7	01/2010	Revised reference for LE reporting

#### *Effective date*

**CM-A.3.3**

The contents of this Module are effective from July 2004 or the dates given in the summary of changes above.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-B:</b>	<b>General guidance and best practice</b>

## **CM-B.1 Guidance provided by international bodies**

### ***Basel Committee: Principles for the Management of Credit Risk***

CM-B.1.1 The paper (see [www.bis.org/publ/bcbs75.pdf](http://www.bis.org/publ/bcbs75.pdf)) which contains 17 principles, encourages banking supervisors globally to promote sound practices for managing credit risks in banking activities.

CM-B.1.2 Throughout the Module, references have been made to this paper and it is recommended that the regulations in this Module be followed in conjunction with the guidelines presented in this paper.

### ***Counterparty Risk Management Policy Group (CRMPG): Improving Counterparty Risk Management***

CM-B.1.3 The objective of this report (see [www.isda.org/educat/pdf/CRMPG-report6-99.pdf](http://www.isda.org/educat/pdf/CRMPG-report6-99.pdf)), which was developed by a committee of market practitioners in the wake of the 1998 market disruptions, discusses counterparty credit risk and market risk management practices and how they can be enhanced.

CM-B.1.4 The report covers four subject areas: transparency and counterparty credit assessments; risk measurement, management, and reporting; market practices and conventions; and regulatory reporting.

CM-B.1.5 Of particular interest to risk managers is guidance provided in two areas, one on liquidity risk and leverage, and the other on counterparty credit exposure estimation.

### ***Basel Committee: Framework for Internal Control Systems in Banking Organisations***

CM-B.1.6 The paper (see [www.bis.org/publ/bcbs40.pdf](http://www.bis.org/publ/bcbs40.pdf)) issued in September 1998 presents the first internationally accepted framework for supervisors to use in evaluating the effectiveness of the internal controls over all on- and off-balance-sheet activities of banking organisations.

CM-B.1.7 The paper describes elements that are essential to a sound internal control system, recommends principles that supervisors can apply in evaluating such systems, and discusses the role of bank supervisors and external auditors in this assessment process.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-1:</b>	<b>General procedures</b>

## **CM-1.1 Overview**

**CM-1.1.1** Credit risk is the likelihood that a counterparty of the bank will not meet its obligations in accordance with the agreed terms. The magnitude of the credit risk depends on the likelihood of default by the counterparty, and on the potential value of the bank's contracts with the customer at the time of default. Credit risk largely arises in assets shown on the balance sheet, but it can also show up off the balance sheet in a variety of contingent obligations.

**CM-1.1.2** Exposure to credit risk, notably in the form of traditional bank lending, has historically been the most frequent source of bank problems. The assessment of credit risk is a challenging task where bankers are often faced with making decisions based on outdated or partial information.

**CM-1.1.3** The lack of continuous loan supervision and effective internal controls, or the failure to identify abuse and fraud are also sources of risk. The overall lending policy of the bank should be monitored by a Credit Committee composed of officers with adequate seniority and experience.



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## **CM-1.2 Credit analysis**

**CM-1.2.1** Proper credit risk management will help banks to discipline their lending activities and ensure that credit facilities are granted on a sound basis, and that bank funds are invested in a profitable manner. The process of managing credit risk starts at the origination of the credit facility. Standards for credit analysis should stress the borrower's ability to meet his future financial needs through analysis of his cash-flow generation capacity.

**CM-1.2.2** Measurement of credit risk is complicated by the fact that both credit exposures and the likelihood of default can vary over time and may be interdependent. The creditworthiness of customers shifts, as reflected in credit rating upgrades and downgrades. Customers that originally are highly rated are more likely to default later in a loan's life than earlier.

**CM-1.2.3** Banks should properly assess the inherent risk factor of each credit facility; monitor the risks arising from any portfolio concentration; and ensure that appropriate precautions against losses have been taken in the form of collateral and/or provisioning as described in Chapter CM-2.

### **CM-1.2.4**

All banks which provide credit facilities to resident natural persons in Bahrain must become members of the Credit Reference Bureau. Membership of the CRB is therefore compulsory for all Retail Banks. All requests by residents of Bahrain for new credit facilities must be submitted to the CRB. The CBB will selectively sample all such credit facilities issued or renewed by CBB licensees to ensure that they are submitting all these requests to the CRB.

### **CM-1.2.5**

All CRB members must fully abide by the agreed Code of Practice of the CRB (see Appendix CM-3), in matters such as the protection of confidential customer data and payment of enquiry fees. Any such breaches will be viewed as calling into question the "fit and proper status" of persons involved, potentially making the licensee and the person liable to enforcement action by the CBB.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
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## **CM-1.3 Credit policy**

**CM-1.3.1** A properly documented credit policy is an essential element of and prerequisite for the credit risk management process. Consistent with the Board's objectives, it assists bank management in the maintenance of proper credit standards and the avoidance of unnecessary risks.

**CM-1.3.2** It is prudent to review the credit policy regularly to ensure that once it is established, it remains flexible enough to be current and continues to accomplish its original purpose taking into consideration market developments.

**CM-1.3.3** Explicit guidelines in credit policy provide the basis for effective credit portfolio management. A sound credit policy should consider which types of credit products and borrowers the bank is looking for and the underwriting standards the bank will utilize.

**CM-1.3.4** A bank's credit policy should address all credit matters of significance including:

- (a) objectives of credit monitoring;
- (b) organisation and reporting structure of the credit department;
- (c) designated markets and products;
- (d) establishment of a credit limit framework;
- (e) guidelines for assessment of concentration;
- (f) authorisation procedures for the advancement of credit;
- (g) establishment of credit committees;
- (h) establishment of desirable pricing levels and criteria; and
- (i) problem credit identification and administration.

**CM-1.3.5** After the credit facility has been granted, its performance should be monitored at regular intervals. This includes an appropriate periodic review of financial statements, a reassessment of collateral and update of appraisals, and attentive monitoring of conditions in the borrower's industry. Credit supervision constitutes the first line of detection of difficulties and provides the bank with an opportunity to address problems before losses are sustained.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2:</b>	<b>Assessment of credit quality</b>

## **CM-2.1 Overview**

**CM-2.1.1** A realistic assessment of credit quality is an essential feature of effective credit risk management. The starting point for a systematic review of credit quality is a comprehensive review of the bank's written credit policies and practices. These include, but are not limited to:

- (a) credit approval procedures;
- (b) credit underwriting criteria; and
- (c) credit administration processes.

**CM-2.1.2** Credit quality is a relative concept based on performance prospects and external variables. Trends in the economy and changes in markets and prices of goods affect the evaluation of loan repayment value. Assessing credit risk is a dynamic concept which needs to take into account the business cycle and the economic environment.

**CM-2.1.3** The objectives of the credit assessment are to determine:

- (a) whether the applicant/customer will have sufficient future liquid resources to honour credit obligations according to the agreed terms;
- (b) whether the applicant's/customer's present and future prospects indicate that they will continue as a going concern in the foreseeable future;
- (c) is the applicant / customer of sufficient integrity; and
- (d) to what extent does any security offered affect the risk inherent in the facility.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2:</b>	<b>Assessment of credit quality</b>

## **CM-2.2 Credit ratings**

**CM-2.2.1** Credit officers should assign credit ratings to the loans they originate. This will help the Credit Committee to assess the credit judgement in assigning credit ratings and pricing for credits. The ratings should have several categories with additional breakdowns in each Category:

- (a) '*Standard credits*' are those which are performing as the contract requires. There is no reason to suspect that the creditor's financial condition or collateral adequacy has depreciated in any way. The bank is very likely to extend additional funds to this borrower if requested (subject to internal or legal credit restrictions);
- (b) '*Watch credits*' are currently protected from loss but are potentially weak; they constitute a risk, but the risk is not such that it justifies a rating of Substandard;
- (c) '*Substandard credits*' are inadequately protected by the paying capacity of the obligor or by the collateral pledged. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard assets does not have to exist in individual assets classified Substandard;
- (d) '*Doubtful credits*' have all the weaknesses inherent in a credit classified as Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable or improbable. The possibility of Loss is extremely high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the asset, its rating as an estimated Loss is deferred until its more exact status may be determined;
- (e) '*Loss credits*' are considered uncollectable and of such little value that their continuance as assets is not warranted. The rating does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2:</b>	<b>Assessment of credit quality</b>

**CM-2.2.2** The classification should normally apply to the entire balance of an outstanding facility because if a problem exists with the one credit, it normally applies to the whole facility and not just the payment or individual credit, which may be overdue. This is a conservative approach, which will alert bank management and the Board to the full extent of a potential problem.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2:</b>	<b>Assessment of credit quality</b>

## **CM-2.3 Collateral**

**CM-2.3.1** The extension of credit is often supported by collateral provided by the customer or third parties. When the loan decision is based on collateral value, independent timely appraisals of the collateral should be obligatory, including provision for sufficient security margins.

**CM-2.3.2** In principle, collateral can improve the credit rating of a customer, but experience suggests that over-reliance on collateral is unsound because very often when a loan goes sour the collateral turns out to have less value than estimated or is, at worst, illusory.

**CM-2.3.3** Misjudgements about collectability are frequently the cause; collateral is often illiquid, difficult to value during periods of financial distress and costly to realise through foreclosure or other legal means. Particular concern may be appropriate in the case of collateral in the form of real estate, as it involves additional uncertainties and the costs of maintaining the property.

**CM-2.3.4** As a matter of principle, collateral should not replace a careful assessment of the borrower's ability to repay.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-3:</b>	<b>Developing a sound credit culture</b>

## **CM-3.1 Overview**

**CM-3.1.1** Credit culture is defined as the sum total of a bank's approach to managing credit risk, including business strategy, credit policy, shared assumptions about credit, the effectiveness of communications, and the composition and quality of the resulting loan portfolio.

**CM-3.1.2** As a matter of best practice, all banks should periodically review their credit cultures in order to reduce future credit losses and also to minimise reputational risk and damage to their credit ratings.

**CM-3.1.3** The Central Bank draws all licensed banks' attention to the September 2000 document issued by the Basel Committee entitled 'Principles for the Management of Credit Risk'. This document contains 17 principles which all banks should ensure are covered in their credit culture (i.e. policies, procedures, systems and controls) (see [www.bis.org/publ/bcbs75.pdf](http://www.bis.org/publ/bcbs75.pdf)).

**CM-3.1.4** Effective from the date of the original circular (see Section CM-A.3), the Central Bank will use the Basel document mentioned above as a guideline in its evaluation of the credit cultures of banks operating in Bahrain. Evaluation will be implemented through prudential meetings, inspection and reporting accountants' reviews.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-3:</b>	<b>Developing a sound credit culture</b>

## **CM-3.2 Elements of a strong credit culture**

**CM-3.2.1** First, the regulation in this Section is recommendatory in nature (except for the requirement in Paragraphs CM-3.2.2 (a) & (e) below), and the guidelines below under the five headings are indicative of best practice. Some of the guidelines may not be appropriate to all relevant licensees. However, if a bank is not following these guidelines, it should consider why it is not doing so.

**CM-3.2.2** Secondly, the regulation in this Section is intended as a complement to the September 2000 Paper by the Basel Committee entitled 'Principles for the Management of Credit Risk' (see Section CM-B.2). This Section does not summarise the Basel Paper, but is intended to be read in conjunction with the above Paper.

### **(a) The Role of the Board of Directors**

The Board of Directors must approve all the operating policies of a bank (see principle 1 of Basel Committee paper, 'Framework for Internal Control Systems in Banking Organisations' – Section CM-B.2).

Given that credit risk is still the major risk that banks are exposed to in their business, particular scrutiny must be paid to credit policies, in terms of various limits as well as in terms of risk strategy. An essential function of the Board is to review and reassess the credit policies of the bank (including collateral, provisioning policies and concentration policies) on a periodic basis. The Board should also regularly review overdue and large facilities both in terms of performance, and also in relation to the capital (base) of the bank. The Board should insist upon periodic review/evaluation of internal systems and control weaknesses identified by external/internal auditors and management. Principle 1 of the Basel Committee paper 'Principles for the Management of Credit Risk' (see Section CM-B.2) also gives greater detail on the role of the Board in developing a sound credit culture.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM 3:</b>	<b>Developing a sound credit culture</b>

**(b) The Role of the senior management**

Senior Management should be involved in regular reviews of outstanding facilities and overdue accounts as well as reviewing changes in activity, turnover or balances in clients' accounts. The role of senior management is covered in depth in Principle 2 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2 (see also Principle 3 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2). However, Senior Management should be involved in the credit review process of (larger) existing facilities, visiting clients, requesting up to date financial statements and verifying collateral. Too often, a lack of direct contact by senior management with a problem client has been an identified factor in significant credit losses by banks, whether by way of fraud, or corporate failure.

**(c) Role of an Independent Risk Management Function**

Perhaps the key point to emphasise in Risk Management is that the function must be independent of the senior management and operational functions which are related to business acquisition. The Risk Management function should report to the Board or to senior management related to control functions. The Risk Management function must not only monitor risk, but also control it (i.e. review limits, excesses etc). It must also ensure that risk monitoring systems accurately measure risk in the first place, and that all risks where they occur are correctly identified (see also Principle 6 of Basel Committee paper, 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2).

**(d) Effective Internal Systems and Controls**

Well implemented sound policies and procedures maintain credit standards, enable monitoring and control of credit risk, and identify problem credits in a timely manner (see Principle 2 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2 for more detail). Sound policy and administrative requirements also apply equally strongly to existing facilities as well as new ones (see Principle 8 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2). Policies and procedures should allow a thorough understanding of the counterparty, the purpose of the credit facility and the source of repayment (Principle 4 of Basel Committee paper 'Principles for the Management of Credit Risk' – Section CM-B.2) to be gained by the Risk Management function in its assessment of the counterparty for risk profiling purposes, (see also Principle 6 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2 and Section E of the paper issued by the Counterparty Risk Management Policy Group - 'Improving Counterparty Risk Management' – see Section CM-B.2). Banks should seek to utilise internal rating systems to manage credit risk and to set adequate provisions on a timely basis (see Principle 10 of Basel Committee paper 'Framework for Internal Controls Systems in Banking Organisations' – Section CM-B.2 and also the Credit Ratings in Section CM-2.2).



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-3:</b>	<b>Developing a sound credit culture</b>

**(e) The Role of Internal Audit**

The internal audit function must, on an on-going basis, monitor the system of internal controls because it provides an independent assessment of the adequacy of, and compliance with, the established policies and procedures. The internal audit function must report directly to the highest levels of the banking organisation, typically the Board of Directors or its audit committee, and to senior management. This allows for the proper functioning of corporate governance by giving the Board information that is not biased in any way by the levels of management that the reports cover.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-3:</b>	<b>Developing a sound credit culture</b>

### **CM-3.3 Name-lending**

**CM-3.3.1** Banks are exposed to credit risk when they provide large credit facilities on a 'clean' basis (i.e. without collateral or security). This risk is amplified, specifically, when such clean lending is made without adequate (up to date) financial information.

**CM-3.3.2** In many banks there is a tendency to indulge in 'name-lending' without any credit analysis or understanding of the concerned counterparty's current borrowings from other banks. The Central Bank strongly discourages the banks to engage in such activities in order to minimise their credit risk and reputational risk.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-4:</b>	<b>Provisioning</b>

## **CM-4.1 Overview**

**CM-4.1.1** Credit rating (see Section CM-2.2) provides a basis for determining an adequate level of provisions for possible loan losses. The loss potential within specific credits will have to be determined on a case by case basis after all credit and collateral factors have been evaluated. Such potential losses, together with a general provision for the remainder of the portfolio where specific risks have not been identified, form the basis for establishing an adequate level of provisions.

**CM-4.1.2** For the purpose of this Chapter, 'Non-performing loans' are those on which payments of interest or repayments of principal are 90 days or more past due.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-4:</b>	<b>Provisioning</b>

## **CM-4.2 Implications of IAS 39**

### *Interest in suspense*

**CM-4.2.1** Banks should suspend interest on loans and advances which are 90 days or more past due.

### *IAS 39 transitional adjustments for provisions*

**CM-4.2.2** All IAS 39 transitional provisions must be routed through the retained earnings account with the exception of provisions.

**CM-4.2.3** Under the IAS 39, as of 31 December 2000, the banks will have two options for the treatment of general provisions after considering the pooled general and specific provisions and interest in suspense balances in comparison to the estimated provisions resulting from the discounting of future cash flows. These options are:

- (a) Any excess general provisions balance brought forward over and above the newly estimated figure may be transferred directly to general reserves, or
- (b) Where provisions (or impairment allowances) relate to a portfolio of homogeneous loans (e.g. consumer loans) then such excess provisions may continue to be treated as a general provision for capital adequacy purposes (see Module CA).



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-4:</b>	<b>Provisioning</b>

## **CM-4.3 Provisioning policies of branches of Foreign Banks in Bahrain**

**CM-4.3.1** The Central Bank has, for some time, been monitoring the practices adopted by branches of foreign banks in Bahrain with regard to the making and maintaining of provisions against bad and doubtful debts in their books in Bahrain. The Central Bank is aware that it is the policy of some foreign banks in Bahrain to maintain provisions at their head offices, and not in their books in Bahrain. In the interests of prudence, the Central Bank has reviewed this matter and issues this Regulation to reflect its requirements in this area.

**CM-4.3.2** Specific provisions for the bad and doubtful debts (as well as any other non-performing assets) of branch(es) of foreign banks in Bahrain are expected to be maintained in the books of Bahrain branch(es).

**CM-4.3.3** If the bank is not able to meet this requirement in Paragraph CM-4.3.2 above, then the bank's head office should advise the Central Bank, on an annual basis and in writing, of the amount of provisions set aside for the Bahrain branch(es)'s bad debts (and any other non-performing assets).

**CM-4.3.4** In addition, the Central Bank may contact the bank's parent supervisor, on a regular or ad hoc basis, in order to obtain information about the adequacy of the provisioning for such assets.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-4:</b>	<b>Provisioning</b>

## **CM-4.4 Provisions against sovereign debt**

**CM-4.4.1** The Central Bank has consistently encouraged banks to maintain adequate provisions against loans to borrowers experiencing difficulties and against loans for countries with current or potential debt servicing difficulties.

**CM-4.4.2** In all cases the assessment of loans - and decisions regarding adequate provisions - are assisted by the categorization of loans as defined by the Central Bank in Section CM-2.2. In addition, with regard to 'sovereign debt' it is particularly important that the size of the provisions made should be based on the identification and objective assessment of the nature and extent of difficulties being experienced by particular countries and reflect as near as possible deterioration in the prospects for recovering debts. With these objectives in mind, the Sovereign Debt Provisioning Matrix (see Appendix CM-1) contains a list of measurements which have been designed to help identify those borrowers and countries with payment difficulties and to decide what would constitute adequate provisions.

**CM-4.4.3** It is emphasized that this Section and the Sovereign Debt Provisioning Matrix (see Appendix CM-1) are merely a general framework for assessing degrees of provisions. They should not be regarded as an exhaustive or definitive framework. Nevertheless, the Central Bank does intend to include the results of banks' calculations in its discussions with them, and to establish that adequate provisions are being made.

***Implications of International Accounting Standard (IAS) no. 39 on the provisions assessed through Sovereign Debt Provisioning Matrix***

**CM-4.4.4**

The banks should continue to apply the Sovereign Debt Provisioning Matrix (see Appendix CM-1) as a benchmark for estimating future recoverable cash receipts. However, if a lower provisioning amount is determined, i.e. lower than the amount identified through the matrix, and the bank intends to book the lower amount, then a meeting must be arranged with the Central Bank to discuss the issues before booking such provisions.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-5:</b>	<b>The monitoring and control of large exposures of banks licensed by the Central Bank</b>

## **CM-5.1 Overview**

**CM-5.1.1** The Regulation on large exposures for banks in Bahrain is issued as part of the Central Bank's measures to encourage banks to mitigate risk concentrations.

**CM-5.1.2** The contents of this Chapter apply in full to all locally incorporated banks in the Kingdom of Bahrain on a consolidated basis.

**CM-5.1.3** Banks , through the PIRC forms (see Module CA), should notify the Central Bank of the group companies to be consolidated for reporting purposes.

**CM-5.1.4** The Central Bank will, as appropriate, discuss the application of this Chapter to relevant banks on an unconsolidated basis.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-5:</b>	<b>The monitoring and control of large exposures of banks licensed by the Central Bank</b>

**CM-5.2 Exposures undertaken by Bahrain branches of Foreign Banks ('the Foreign Branches')**

**CM-5.2.1**

The Central Bank's policy towards large exposures on the books of Foreign Branches is to ensure that such exposures are within the policy statement of the parent bank, as agreed by the parent regulatory authority.

**CM-5.2.2**

All Foreign Branches should report their 25 largest exposures to the Central Bank.

**CM-5.2.3**

The Central Bank may, if circumstances so require and on a case-by-case basis, apply the full requirements of this Chapter to Foreign Branches.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
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### **CM-5.3 The measure of exposure**

#### **CM-5.3.1**

For large exposure(s) purposes, the measure of exposure should reflect the maximum loss that will arise should a counterparty fail or the loss that may arise due to the realisation of any lending assets, shareholdings or other exposures or off-balance sheet positions. In certain cases (particularly derivatives), the measure of a large exposure may be larger than that used in published accounts. Consistent with this, the exposure should include the amount at risk arising from a bank's:

- (a) Claims on a counterparty including actual claims, and potential claims which would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) which the bank has committed itself to provide, and claims which the bank has committed itself to purchase or underwrite. In the case of undrawn (overdraft) facilities, the advised limit must be included in the measure of exposure (after deduction of any provisions). In the case of loans, the net outstanding balance as shown in the books of the bank should be included in the measure of exposure after deduction of any provisions;
- (b) Contingent liabilities arising in the normal course of business, and those contingent liabilities which would arise from the drawing down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) which the bank has committed itself to provide. In the case of undrawn L/C or similar facilities, the advised limit must be included in the measure of exposure;
- (c) Holdings of equity capital, bonds, bills or other financial instruments. In the case of equity exposures, the current fair value as shown in the books of the bank should be included in the measure of exposure.
- (d) Other assets which constitute a claim for the bank and which are not included in (a), (b) or (c) above.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
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**CM-5.3.2**

As a general rule, exposures should be reported on a gross basis (i.e. no offset). However, debit balances on accounts may be offset against credit balances on other accounts with the bank if:

- (a) a legally enforceable right of set off exists in all cases (as confirmed by a legal opinion addressed to the bank) in respect of the recognised amounts;
- (b) the debit and credit balances relate to the same customer or to customers in the same group; and
- (c) the bank intends either to settle on a net basis, or to realise the debit balances and settle the credit balances simultaneously.

For a group facility, a full cross guarantee structure must also exist before debit balances on accounts may be offset.

**CM-5.3.3**

Large exposures are calculated using the sum of the nominal amounts before the application of risk weighting and credit conversion factors for:

- (a) on-balance sheet claims;
- (b) guarantees and other contingent claims; and
- (c) potential claims in the case of undrawn facilities.

The amount at risk from derivative contracts is taken to be the credit equivalent amount calculated based on the guidelines for the prudential returns (see Module CA).

**CM-5.3.4**

A bank's exposure arising from securities' trading operations is calculated as its net long position in a particular security (a short position in one security issue may not be offset against a long position in another issue made by the same issuer). A bank's 'net long position' in a security refers to its commitment to buy that security together with its current holdings of the same security, less its commitment to sell such securities.



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## **CM-5.4 Identity of counterparty**

**CM-5.4.1**

For the purposes of measuring exposures, the counterparty will generally be the borrower (customer), the person guaranteed, the issuer of a security in the case of a security held, or the party with whom a contract was made in the case of a derivative contract.

**CM-5.4.2**

Where a third party has provided an explicit unconditional irrevocable guarantee, and subject to the guaranteed bank's policy statement not stating otherwise, the guaranteed bank may be permitted to report the exposure as being to the third party guarantor.



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## **CM-5.5    Limits for large exposures**

### *Aggregate limit on large exposures – 800%*

**CM-5.5.1**

The aggregate of large exposures may not exceed 800% of the bank's (consolidated) capital base.

**CM-5.5.2**

'Capital base' is the adjusted capital base for the purpose of the risk asset ratio calculated in accordance with the PIR/PIRC return (see Module CA).

**CM-5.5.3**

A 'large exposure' is any exposure to counterparty or a group of closely related counterparties which is greater than, or equal to, 10% of (consolidated) capital base.

### *Single exposure limit – 15%*

**CM-5.5.4**

A bank may not incur an exposure to an individual counterparty or group of closely related counterparties which exceeds 15% of the reporting bank's (consolidated) capital base.

**CM-5.5.5**

'Closely related counterparties' are two or more counterparties who constitute a single risk because one of them has, directly or indirectly, a controlling interest in the other(s) (i.e. 20% or more equity voting rights), or counterparties connected in such a way that the financial soundness of any one of them may affect the financial soundness of the other(s), or the same factors may affect the financial soundness of both or all of them.

**CM-5.5.6**

'Controlling interest' means either significant ownership or any other interests (including, but not limited to, the ability to exercise or control the exercising of voting power of issued share capital in the licensee) which enable the holder, or which would enable a proposed transferee, thereof to exercise significant influence over the management and business of the licensee.



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***Limit on exposures to connected counterparties – 40% aggregate***

**CM-5.5.7** Exposures to connected counterparties may be justified only when undertaken for the clear commercial advantage of the bank, when negotiated and agreed on an arm's length basis, and when included in the large exposures policy statement agreed with the Central Bank.

**CM-5.5.8** No lending by a bank to its own external auditors shall be permitted. In this context, 'external auditors' refers to the firm/partnership, the partners, the Directors and managers. For those conventional banks which provide Islamic banking services, no lending to members of the Shari'a Board shall be permitted.

**CM-5.5.9** For the purpose of this module, 'Connected counterparties' includes companies or persons connected with the bank, including in particular subsidiaries and associated companies (whether such association is due to control or shareholding or otherwise), Directors and their associates (whether such association is due to control or family links or otherwise), management, and shareholders holding 10% or more of the voting power of the bank. In this context, family links means spouse, father, mother, sons, daughters, sisters and brothers.

**CM-5.5.10** Exposures to all connected counterparties listed below when taken together, may not exceed 40% of (consolidated) capital base.

<b>Connected Counterparties</b>	<b>Individual Limit</b>	<b>Aggregate Limit</b>
Shareholders with 'significant ownership (i.e. 10% and above)'	0%	0%
Directors	10%	20%
Associated Companies /Unconsolidated subsidiaries	15%	20%
Total (including management)		40%



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**CM-5.5.11**

Lending to senior management is covered under Chapter CM-6. All credit facilities to senior management will be included under the total connected counterparties limit of 40% of capital base.

*Limit on exposures to shareholders*

**CM-5.5.12**

Shareholders with significant ownership of the bank's capital (10% and above) are not allowed to borrow from the bank (i.e. a 0% limit), however smaller shareholders will be subject to the normal 15% limit on an individual basis. Directors who are also shareholders with significant ownership are subject to the 0% limit mentioned above.

*Deductions from capital base*

**CM-5.5.13**

The Central Bank will examine particularly closely all exposures to companies or persons connected to a bank and will deduct them from the bank's (consolidated) capital base if they are, in the Central Bank's opinion, of the nature of a capital investment, or provision of long-term working capital, or are made on particularly concessionary terms.

**CM-5.5.14**

Any other form of connected lending outside the scope of the above will be dealt with by the Central Bank on a case-by-case basis.



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## **CM-5.6    Exempt exposures**

**CM-5.6.1**

Certain types of exposure are exempt from the limits set out above, but notification of such exposures should be made to the Central Bank on a quarterly basis in the format provided in Appendix BR-3.

**CM-5.6.2**

These exemptions fall into the following categories and are subject, in each case, to the policy statement as agreed with the Central Bank:

- (a) short term (i.e. up to six months original maturity) interbank exposures;
- (b) exposures to GCC governments, their semi-governmental institutions and agencies that do not operate on a commercial basis, as set out in the guidelines to the PIR/PIRC (see Module CA);
- (c) exposures to OECD central governments or exposures secured by OECD central government securities / guarantees;
- (d) exposures secured by cash or GCC government securities/guarantees;
- (e) certain connected exposures, in particular those arising from a group Treasury function (see Paragraphs CM-5.6.3 to CM-5.6.6);
- (f) exposures which are covered by a guarantee from the bank's parent (see Paragraphs CM-5.6.7 to CM-5.6.10); and
- (g) exposures arising from underwriting activities, such exposures continuing for no more than 90 calendar days. Underwriting exposures should normally be part of the trading book of a bank. Any residual holdings of securities held for more than 90 days from the commitment date of underwriting are no longer exempt and are subject to normal large exposure limits.

### *Exempt exposures to connected counterparties*

**CM-5.6.3**

Exposures to subsidiaries which are always fully consolidated on a line-by-line basis for all supervisory purposes are exempt, however banks should bear in mind the capital adequacy requirements on a solo basis.



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**CM-5.6.4**

Exposures to unconsolidated subsidiaries are not exempt and will be included under the limits for exposures to associated companies.

**CM-5.6.5**

In respect of exposures to other connected counterparties, the Central Bank will allow a bank to take on a Treasury role on behalf of the group as a whole (provided that the group is subject to consolidated supervision by its home supervisor). The Central Bank's policy regarding the taking on of a Treasury role includes exposures arising from a central risk management function.

**CM-5.6.6**

In the above scenario (Paragraph CM-5.6.5), for example, exposures of more than 15% of the capital base to a parent bank from a subsidiary bank may be permitted where they constitute short term lending of excess liquid funds.

#### *Exposures undertaken by a subsidiary bank*

**CM-5.6.7**

Where exposures undertaken by a Bahrain subsidiary of an overseas bank are guaranteed by its parent, the Bahrain subsidiary bank may be deemed to have an exposure to its parent.

**CM-5.6.8**

Under the terms of this module (see Paragraph CM-5.6.2), such indirect exposures to a parent bank may be exempt from the limits on large exposures if the Central Bank is satisfied that:

- (a) such exposures are entered into within the terms of a policy agreed by the parent bank, and
- (b) there are guarantees in place from the parent bank to protect the subsidiary should the exposure become impaired or require to be written off.



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**CM-5.6.9**

In the case of a Bahrain incorporated bank's subsidiary inside Bahrain, in order for an exposure exceeding 15% of capital base to be acceptable in the subsidiary, the Bahrain parent must at all times have the capacity to take on the exposure to the third party, without itself exceeding the limit of 15% of capital base. Also, the total exposure of the banking group to the customer must be within 15% of the parent bank's consolidated capital base.

**CM-5.6.10**

The Central Bank will need to be satisfied that adequate control systems are in place to ensure that risks taken in the group as a whole are properly monitored and controlled.



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<b>CHAPTER</b>	<b>CM-5:</b>	<b>The monitoring and control of large exposures of banks licensed by the Central Bank</b>

## **CM-5.7 Reporting of exposures**

**CM-5.7.1**

Bahrain incorporated banks are required to report (for the attention of the Director of Banking Supervision Directorate) all large exposures, (whether exempt or not) on a quarterly basis using the Form PIR provided in Appendix BR-5 as well as their exposures to connected parties on a monthly basis using the form provided in Appendix BR-11.

**CM-5.7.2**

Banks are required to adopt policies and set internal limits, which will not lead to the exposure limit(s) referred to above being exceeded as a matter of course.

**CM-5.7.3**

For some banks, the Central Bank may determine it prudent to set a lower percentage(s) than the ones given herein.

**CM-5.7.4**

Should any bank find that, for reasons outside its control or otherwise, it has an exposure to an individual counterparty (other than an exempt exposure) which results in it exceeding any of the limits set out above, this should be reported immediately to the Central Bank for its consideration, and action should be taken to immediately bring the exposure back within applicable limits as soon as possible.



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## **CM-5.8 Policy statements**

**CM-5.8.1**

The Central Bank requires each Bahrain incorporated bank to set out its policy on large exposures, including limits for differing types of exposures to individual customers, banks, corporates, countries and economic and market sectors, in a policy statement which should be formally approved by the Board of Directors. Furthermore, banks should not implement significant changes to these policies without prior discussion with the Central Bank.

**CM-5.8.2**

The policy statement should identify 'connected counterparties' and the bank's policies towards lending to and investing in these counterparties.

**CM-5.8.3**

The bank should explain and justify any requests for exemptions for lending to/investments in connected counterparties.

**CM-5.8.4**

Each bank will be expected to justify to the Central Bank in the policy document its policy on exposures to individual counterparties, including the maximum size of an exposure contemplated.

**CM-5.8.5**

Exposures to counterparties connected with the bank will continue to be particularly closely examined.

**CM-5.8.6**

The necessary control systems to give effect to a bank's policy on large exposures should be clearly specified and monitored by its Board.

**CM-5.8.7**

Banks are required to implement appropriate internal systems and controls to monitor the size of their capital base on a daily basis to ensure that the limits detailed in this module are not exceeded.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
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## **CM-5.9 Concentrations in economic and market sectors**

**CM-5.9.1** The extent to which a bank may be prudently exposed to a particular economic sector will vary considerably depending upon the characteristics and strategy of the bank, and the sector concerned.

**CM-5.9.2** Concentrations should also be recognised in not just economic sectors, but also in markets (e.g. individual stock exchanges). The Central Bank will not apply common maximum percentages to banks' sectoral or market exposures but, instead, will continue to monitor such exposures on an individual and general basis.

**CM-5.9.3** Banks must specify in their policy statements how they define economic and market sectors, and what limits apply to differing sectors.

**CM-5.9.4** Exposures and limits for sectors should be reviewed at least quarterly by the Board of Directors.

**CM-5.9.5** Banks which have over 10% of their risk-adjusted assets in market risk (i.e. the trading book) must also set market risk concentration limits.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-6:</b>	<b>Staff loans</b>

## **CM-6.1 Reporting and compliance**

**CM-6.1.1**

The Central Bank's prior written consent should be obtained for any loan to an employee where the amount of such loan, either singly or when added to an existing loan(s) outstanding to that employee at that date, would be equal to or in excess of BD 100,000, or its equivalent in foreign currency. Banks must notify the Central Bank in writing of any senior employee who fails to discharge his repayment obligations.

**CM-6.1.2**

Banks must ensure that the provisions of relevant laws (including, specifically, the Bahrain Labour Law) are observed at all times in this area.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-7:</b>	<b>Write-off – Credit facility</b>

## **CM-7.1 Write-offs**

**CM-7.1.1**

All locally incorporated banks should notify the Central Bank of any write-off of a credit facility, (i.e., loan, overdraft and any other credit facility) of an amount in excess of BD 100,000, or its equivalent in foreign currency.

**CM-7.1.2**

Such notification should be accompanied by documentary evidence showing, beyond reasonable doubt, that the customer does not possess the resources to fulfil the outstanding obligation.

**CM-7.1.3**

Banks should also obtain the CBB's prior written approval before writing off any of the following:

- (a) exposures to any present or former Director of the bank;
- (b) exposures which are guaranteed by a Director of the bank;
- (c) exposures to any business entity for which the bank or any of its Directors is an agent;
- (d) exposures to any officer or employee of the bank, or any other person who receives remuneration from the bank;
- (e) exposures to any business entity in which the bank (or any of its Directors, officers or other persons receiving remuneration from the bank) has a material interest as a shareholder (i.e. 5% or more), or as a Director, manager, agent or guarantor; and
- (f) exposures to any person who is a Director, manager or officer of another bank licensed by the Central Bank.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-8:</b>	<b>Consumer finance</b>

## **CM-8.1 Overview**

**CM-8.1.1**

This Chapter sets out various requirements regarding the provision of consumer finance within the Kingdom of Bahrain, by the CBB licensees. The aim of these requirements is to encourage:

- (a) prudent lending by licensees providing consumer finance; and
- (b) the transparent disclosure of the full costs and terms on which licensees offer consumer finance.

### *Application date*

**CM-8.1.2**

The content of this Chapter is to be applied to all consumer finance facilities entered into or renewed after 1 January 2005. The application date of the “Code of Best Practice on Consumer Credit and Charging” is 1 September 2007. All conventional banks which offer consumer finance facilities to residents of Bahrain must follow the Code after 1 September 2007. Failure to observe the requirements of this Chapter or the Code may result in Enforcement Action under module EN. The Code is attached as Appendix CM-2 in Part B of the Rulebook.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM 8:</b>	<b>Consumer finance</b>

## **CM-8.2 The Central Bank's approach to consumer finance**

**CM-8.2.1** The Central Bank favours an open, market-based approach to the operations of licensees, to the extent consistent with its regulatory objectives of ensuring a stable financial system and the fair treatment of licensees' customers.

**CM-8.2.2** **Bank licensees are reminded of their obligation to implement a sound internal controls framework, including an effective credit culture (see, for instance, Section CM-2.3). Bank licensees are also reminded of their obligations to display and communicate charges and APRs clearly (see, for instance, Section BC-4.3).**

**CM-8.2.3** The Central Bank has noted the growth in consumer finance as a proportion of outstanding credit facilities over the past few years. The Central Bank is concerned that this growth should not be at the cost of declining credit quality. Furthermore, the Central Bank wishes to see further improvements in licensees' transparency in their dealings with their customers, as regards the costs and terms of their lending. Strong competition in this segment of the market increases the need for licensees to be vigilant and to resist pressures to relax standards.

**CM-8.2.4** The measures presented in this Chapter should be viewed as minimum standards, rather than best practice. They are aimed at encouraging prudent lending and full, frank and fair disclosures, rather than dictating comprehensively how licensees should engage in consumer finance. These measures should be read in conjunction with the "Code of Best Practice on Consumer Credit and Charging" which was agreed jointly between the CBB and the Bankers' Society in May 2007.

**CM-8.2.5** These measures will be kept under review in the light of market developments and adjusted accordingly. If the Central Bank assesses that credit quality and effective transparency are being significantly undermined, then additional prescriptive measures will be considered.

### ***On-going effort by the Central Bank***

**CM-8.2.6** These measures form part of a wider response by the Central Bank. The Central Bank recognizes that a key contributor to ensuring a sounder credit environment is the credit reference bureau.

**CM-8.2.7** The Central Bank supervisors and examiners will also focus on banks' implementation of the "Code of Best Practice on Consumer Credit and Charging" in their on-going supervision of licensees, to monitor and encourage sound lending practices and disclosure standards.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-8:</b>	<b>Consumer finance</b>

## **CM-8.3      Definition of Consumer Finance**

**CM-8.3.1**

Consumer finance is the provision of any form of credit facility to an individual excluding:

- (a) any loan secured by a first charge on residential property to an individual, where the borrower lives in, or intends to live in the property;
- (b) any credit facility secured by cash or investments, where the security provided more than covers the principal of the credit facility; and
- (c) the provision of any form of credit to an individual for business purposes where the facility is to be repaid from the business activities of the borrower.

**CM-8.3.2**

For the purposes of the Rulebook, 'credit facility' includes personal overdraft facilities, credit cards, consumer loans or other financing facilities. 'Consumer loans' are defined as loans for a fixed period to individuals for non-business purposes.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-8:</b>	<b>Consumer finance</b>

## **CM-8.4 Maximum limits**

### *Total repayments ratio*

**CM-8.4.1**

Licensees may only provide a new consumer facility (or renew, extend or otherwise modify an existing consumer facility) for an amount such that the borrower's total monthly repayments on all his consumer finance commitments do not exceed 50% of his monthly gross income. This limit may only be exceeded in the circumstances described in Paragraphs CM-8.4.6 and CM-8.4.10.

**CM-8.4.2**

When reviewing an applicant for a consumer facility, licensees may only take into consideration regular income. A spouse's income may only be taken into consideration when the credit facility would be in joint names, such that the spouse would also be legally liable for the obligation incurred.

**CM-8.4.3**

Notwithstanding the above limit, licensees must review in detail an applicant's personal financial standing and ability to service their obligations. Where a spouse's income is being taken into consideration, then their individual circumstances must also be similarly assessed. In many cases, these reviews may require consumer finance repayments to be kept significantly below 50% of monthly gross income.

**CM-8.4.4**

Licensees must enquire as to applicants' sources of income, their past credit history, their regular outgoings and other financial commitments, including potential liabilities such as guarantees. Particular attention should be paid to housing costs (such as payments to the Housing Bank). A person's regular income, net of consumer finance repayments and other financial obligations, must remain sufficient for that person to support himself and any dependents. Licensees should also take into account likely future trends in income and outgoings, and the impact this may have on the 50% ratio.

**CM-8.4.5**

When factoring in credit cards into the repayment limit in Paragraph CM-8.4.1 above, licensees should include 5% of the total of credit limits available on these facilities. If the amounts outstanding (including profit) under such facilities exceed their limit, then this higher amount should be included in full in the repayments ratio calculation. Charge cards are not included under this definition.



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**CM-8.4.6**

In the case of high earners – defined for these purposes as persons earning more than BD 3,000 month - the 50% limit may be relaxed, providing that the licensee has undertaken the review required in Paragraph CM-8.4.4 above and is satisfied that the borrower can comfortably support a higher facility service ratio.

**CM-8.4.7**

The review undertaken to satisfy requirements in Paragraph CM-8.4.4 above must be documented and made available to the Central Bank's examiners on request. The documentation must include all relevant information used to support the decision to extend credit facilities. In the case of high earners granted a facility in excess of the 50% limit, the documentation must also include a written statement, signed by an appropriate member of management, explaining the justification for relaxing the limit.

#### *Maximum tenor limit*

**CM-8.4.8**

The maximum tenor for instalment consumer finance facilities is seven years. The tenor may not be extended more than twice during the period of the agreement.

**CM-8.4.9**

The Central Bank does not believe it prudent for licensees to encourage lending by offering long-term borrowing to fund short-term consumption. The Central Bank will review the development of market practices in this respect and will consider further measures if required.

#### *Non-compliant facilities*

**CM-8.4.10**

Where a customer's monthly gross income falls (e.g. due to redundancy or disability or a similar event outside the control of the customer), the bank must identify such accounts as 'technically non compliant'. If a customer requests an extension to the tenor of the facility due to reduced income, then the bank may increase the term to assist the customer. The bank must take account of the 50% limit outlined in Paragraph CM-8.4.1. Such facilities must also be identified as 'technically non compliant'. Banks must report all 'technically non-compliant facilities' to the Director of Banking Supervision Directorate on a quarterly basis.



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## **CM-8.5 Disclosure requirements**

### *Disclosure of key terms*

**CM-8.5.1**

Licensees must make clear to potential borrowers, prior to entering into a consumer finance agreement, all relevant key terms of the agreement. Licensees must also comply with the disclosure requirements under the “Code of Best Practice on Consumer Credit and Charging” (see Appendix CM-2) as agreed between the Bankers’ Society and the CBB.

**CM-8.5.2**

These terms should be summarised in plain English and Arabic in a short ‘key terms disclosure’ document; this document must be signed and dated by borrowers (in duplicate) as having been read and understood, prior to signing a consumer finance agreement. One copy should be retained by the borrower and the other must be retained by the licensee in their customer file.

**CM-8.5.3**

The ‘key terms disclosure’ document must, amongst other things, make clear:

- (a) the amount being borrowed or the credit limit being offered, its maturity and repayment schedules;
- (b) the nominal rate of interest to be charged on the consumer loan/facility;
- (c) whether this rate of interest is fixed or can go up and / or down, and under what circumstances;
- (d) the basis on which interest is charged and when capital repayments are taken into account in the calculation, together with an illustration of the calculation method;
- (e) a breakdown of all non-interest costs not included in (b), (c) and (d) above and associated with the loan or facility, such as arrangement fees, documentation fees, late payment fees, and obligatory payment protection insurance costs;
- (f) the full costs associated with top-ups of instalment loans or early repayments of amounts due including the treatment of remaining interest and the payment of premium for insurance; and
- (g) the Annual Percentage Rate, as defined in Paragraph CM-8.5.5 below.



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CM-8.5.4

Licensees are free to design the layout and wording to be used in their 'key terms disclosure' document, as they see fit, providing they contain the information specified in Paragraph CM-8.5.3 above. The CBB will monitor compliance with the spirit as well as the letter of the requirements in this Chapter. If necessary, the CBB will consider prescribing a standard template to be used by all licensees engaged in consumer finance.

*Annual Percentage Rate ('APR')*

CM-8.5.5

The APR is a standard measure that allows consumers to compare total charges for credit facilities to be compared on a like-for-like basis. The APR allows the consumer to compare the total charge for credit over differing periods (e.g. - two versus three years) with differing payment profiles and taking into account the payment of any other fees payable as a condition of the contract, such as documentation fees or insurance premiums.

CM-8.5.6

The APR should be shown clearly on the facility document and 'key terms disclosure' document (as set out in Paragraphs CM-8.5.1 to CM-8.5.4 above).

CM-8.5.7

The APR methodology should also be utilised in advertisements for credit. Any deferral of profit or principal announced by the bank should also take account of the APR methodology, and the new APR should be given to the client or made public in advertisements.

CM-8.5.8

The total charge for credit payable by a consumer includes the following items:

- (a) Interest payable on the loan or credit;
- (b) Documentation or administration fees;
- (c) In the case of finance lease contracts, any fees for purchasing the asset (e.g. an option to purchase fee payable at the end of the contract); and
- (d) Any fees or charges payable under any linked or mandatory contract entered into as a condition for the granting of the credit facility, such as payment protection insurance.



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CM-8.5.9

The APR must be calculated using the following methodology:

$$\sum_{K=1}^{K=m} \frac{A_k}{(1 + i) t_k} = \sum_{K'=1}^{K'=m'} \frac{A'k'}{(1 + i) t_k'}$$

CM-8.5.10

The meaning of letters and symbols used in the above formula are:

- K** is the number identifying a particular advance of credit;
- K'** is the number identifying a particular instalment;
- A<sub>k</sub>** is the amount of advance K;
- A'k'** is the amount of instalment K';
- Σ** represents the sum of all the terms indicated;
- m** is the number of advances of credit;
- m'** is the total number of instalments;
- t<sub>k</sub>** is the interval, expressed in years between the relevant date and the date of advance K;
- t<sub>k'</sub>** is the interval expressed in years between the relevant date and the date of instalment K';
- i** is the APR, expressed as a decimal.

CM-8.5.11

For the purpose of this Chapter, the 'relevant date' is the earliest identifiable date on which the borrower is able to acquire anything which is the subject of the agreement (e.g. delivery of goods), or otherwise the 'relevant date' is the date on which the credit agreement is made.

CM-8.5.12

In the case of instalment finance such as a loan, where there is no reimbursement of cost of credit in the event of early repayment, then the residual interest (or cost of credit) in the old loan must be added to the cost of credit for the new facility, and the APR amended accordingly.

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## CM-8.6 Refunds and Prepayments

## ***Refund/Adjustment of Insurance Premium on Loan Prepayments and Top-Ups***

CM-8.6.1

Banks/financing companies must refund/adjust proportionately the insurance premium charged on individual loans when the borrower either requests for a top-up or prepayment of the loan as per the prescribed formula below:

### ***Early Repayment fees/Charges***

CM-8.6.2

The CBB imposes a ceiling on the early repayment charges on consumer and mortgage loans as follows:-

- a. For consumer loans 1% of the outstanding loan amount or BD100 whichever is lower;
- b. For mortgage loans, 0.75% of the outstanding loan amount or BD200 whichever is lower.
- c. The ceilings on the charges have a retroactive effect i.e. covering existing and new loans.