



CREDIT RISK MANAGEMENT MODULE



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**LATEST
VERSION**

CM-8: Islamic contracts

CM-8.1 Overview (Murabaha, Mudaraba, Musharaka, Salam, Istisna'a, Ijarah and Ijarah Muntahia Bittamleek, Qard Hassan).

10/07

APPENDICES

Appendix CM-1: Sovereign Credit Provisioning Matrix
Appendix CM-2: Code of best practice on Consumer Credit and Charging
Appendix CM-3: Bahrain Credit Reference Bureau Code of practice



MODULE	CM: Credit Risk Management
CHAPTER	CM-A: Introduction

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) CBB Reporting Requirements;
- (c) Audit Firms;
- (d) Public Disclosure;
- (e) High-level Controls; and
- (f) Capital Adequacy.

Legal Basis

CM-A.1.3 This Module contains the CBB's Directive relating to the credit risk management of Islamic 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 Islamic 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 credit 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 banks incorporated in Bahrain 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 a combined exposure (funded by unrestricted investment accounts, the bank's own funds and restricted investment accounts) to an individual counterparty or group of closely related counterparties which exceeds 35% of the reporting bank's (consolidated) capital base.
- CM-A.2.4** The aggregate exposures to all connected counterparties when taken together, may not exceed 60% of (consolidated) capital base.
- CM-A.2.5** No Islamic financing provided by a bank to its own external auditors shall be permitted.
- CM-A.2.6** All banks incorporated in Bahrain are required to report (for the attention of the Director of Islamic Financial Institutions Supervision Directorate) all large exposures, (whether exempt or not) on a quarterly basis using the return provided in Appendix BR-3.
- CM-A.2.7** The Central Bank's prior written consent should be obtained for any credit facility to an employee where the amount of such facility, either singly or when added to an existing facility/existing facilities 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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CHAPTER	CM-A: Introduction

CM-A.2.8 Licensees may only provide a new consumer facility (or renew, extend or otherwise modify an existing consumer facility) for an amount such that the counterparty's total monthly repayments on all his consumer finance commitments do not exceed 50% of his monthly gross income.

CM-A.2.9 Licensees must make clear to potential counterparties, 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.2.10 The Central Bank's prior written consent should be obtained before writing off any credit facility provided to 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.2.11 The bank should notify the Central Bank of any write-off of a credit facility, (i.e. Murabaha or any other credit facility) of an amount in excess of BD 100,000 (or its equivalent).

CM-A.2.12 All banks which provide credit to residents of Bahrain must become members of the Credit Reference bureau and follow the CRB Code of Practice (see Appendix CM-3).

CM-A.2.13 All banks are required to follow the CBB's requirements concerning refund of insurance on financing prepayments and top-ups and early repayment fees/charges as outlined in Section CM-7.6.



MODULE	CM: Credit Risk Management
CHAPTER	CM-A: Introduction

CM-A.3 Module History

CM-A.3.1 This Module was first issued on 1st January 2005 as part of the Islamic 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 A list of most recent changes made to this Module are detailed in the table below:

Summary of changes

Module Ref.	Change Date	Description of Changes
CM-2.2	1/10/05	Role of Internal audit becomes a rule
CM-7.4	1/10/05	Clarification re non-compliant facilities
CM-A.1	10/2007	New Rule CA-A.1.4 introduced, categorising this Module as a Directive.
CM-7	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-4.2	10/2007	Clarification of definition of exposure
CM-8	10/2007	Re-organised the Chapter.
CM-4.4 & 6.1	04/2008	New Limits for significant shareholders and guidance on write-offs
CM-7.6	04/2008	New Insurance Refund and prepayment requirements

Evolution of the Module

CM-A.3.3 Prior to the development of this Rulebook, the Central Bank had issued various circulars representing regulations covering different aspects of credit risk management. These circulars and their evolution into this Module are listed below:

Circular Ref.	Date of Issue	Module Ref.	Circular Subject
BC/3/98	21 Feb 1998	CM-B.2	Basel Committee on Banking Supervision Framework for the Evaluation of Internal Controls Systems
BC/117/95 (partial)	1 Feb 1995	CM-1 – CM-3	Risk Management
OG/127/01	18 Mar 2001	CM-2	Developing a Sound Credit Culture
OGD/27/88	9 Feb 1988	CM-3.4	Provisions Against Country Debt
PIRI Pack	-----	CM-4	Prudential Information Returns for Islamic Financial Institutions
EDBC/178/96	5 Oct 1996	CM-5	Islamic Facilities
OG/45/88	13 Mar 1988	CM-6.1	Write-Off – Credit Facility
OG/50/92 (partial)	4 Mar 1992	CM-07.1 – CM-7.2	Consumer Finance
PIRI Pack	-----	CM-8	Prudential Regulations for Islamic Financial Institutions
EDBC/105/96	26 June 1996	CM-8.3	Mudaraba Contracts – Minimum Terms and Conditions
BC/4/99	17 Mar 1999	CM-9.1	Annual Accounts for the Year Ending 31 December 1999



MODULE	CM:	Credit Risk Management
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Effective date

CM-A.3.4

The contents in this Module are effective from the date depicted in the original circulars (see Paragraph CM-A-3.3) or the dates given in the summary of changes above.



MODULE	CM: Credit Risk Management
CHAPTER	CM-B: General guidance and best practice

CM-B.1 Guidance provided by other international bodies

Basel Committee: Principles for the Management of Credit Risk

CM-B.1.1 The paper (see 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), 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 Controls Systems in Banking Organisations

CM-B.1.6 The paper (see 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-1: General procedures

CM-1.1 Overview

- CM-1.1.1 Credit risk is the likelihood that 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 financing, 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 credit 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-1: General procedures

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 credit facilities' 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 residents of 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-1: General procedures

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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-2: Developing a sound credit culture

CM-2.1 Overview

- CM-2.1.1 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 credit portfolio.
- CM-2.1.2 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-2.1.3 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).
- CM-2.1.4 Effective from the date of the original circular (see Section CM-A-3), the Central Bank has used the Basel document mentioned above as a guideline in its evaluation of the credit cultures of banks operating in Bahrain. Evaluation is conducted through prudential meetings, inspection and reporting accountants' reviews.



MODULE	CM: Credit Risk Management
CHAPTER	CM-2: Developing a sound credit culture

CM-2.2 Elements of a strong credit culture

CM-2.2.1 First, the regulation in this Section is recommendatory in nature (except for the requirements in Paragraph CM-2.2.2 (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-2.2.2 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 Controls 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-2: Developing a sound credit culture

(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).



MODULE	CM: Credit Risk Management
CHAPTER	CM-2: Developing a sound credit culture

(e) The Role of Internal Audit

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. 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-2: Developing a sound credit culture

CM-2.3 Name-financing

CM-2.3.1 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 name financing is made without adequate (up to date) financial information.

CM-2.3.2 In many banks there is a tendency to indulge in 'name-financing' without any credit analysis or understanding of the concerned counterparty's current outstanding facilities from other banks. The Central Bank strongly discourages the banks to engage in such activities in order to minimise their credit risk and reputation risk.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

CM-3.1 Overview

CM-3.1.1 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 process.

CM-3.1.2 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 credit facility repayment value. Assessing credit risk is a dynamic concept which needs to take into account the business cycle and the economic environment.

CM-3.1.3 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.

CM-3.1.4 To help improve prudential oversight of credit quality, the Central Bank, in this Module, seeks to establish a set of broad rules that are useful in identifying and containing the impact of impaired assets within banks.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

CM-3.2 Credit grading system

CM-3.2.1 The banks should have in place appropriate credit grading systems (classification) to help assess asset quality and credit exposures including performing receivables.

CM-3.2.2 Credit grading systems offer a number of benefits. Analysis of a bank's entire book can reveal important insights to bank's management in the functioning and ultimately the health of the bank. Credit grading systems provide the means for a more systematic assessment of asset quality. They are particularly useful in assisting in the early detection of asset quality problems within a bank by highlighting credit with above normal risks.

CM-3.2.3 The Central Bank does not favour the imposition of a standard credit grading system for all banks. Instead, the Central Bank will rely, wherever possible, upon the credit grading system adopted by each bank. This preference reflects the fact that banks generally have devoted significant resources to developing grading systems that best fit their individual product mix.

CM-3.2.4 Each bank is hence required to provide to the Central Bank a statement of its current policy in respect of its credit grading system (including definitions used to classify exposures). Banks that do not intend to implement a credit grading system should indicate to the Central Bank their reason for not doing so. The Central Bank expects to have the endorsement of the Board of the bank concerned.

CM-3.2.5 Banks looking to implement a credit grading system, or to update their current system, should consider the following points:

- (a) The system should cover a broad range of the bank's asset portfolio, including unrestricted investment accounts, restricted investment accounts and other off-balance sheet exposures;
- (b) The system should cover both performing and impaired assets - it is common for grading systems to have sufficient range of grades, covering exposures with the lowest risk to those where losses are expected;



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

- (c) Banks should detail credit grading system in a credit policy statement, and should develop procedures for the determination and regular review of the credit risk grades;
- (d) Banks should establish formal forums in the form of committees to review the compliance with the credit policy parameters and the concentration of exposure attributable to various economic and industrial sectors in accordance with the credit policy;
- (e) Particular attention should be given to those facilities which involve a higher normal risk, or which are impaired;
- (f) It is imperative that the policies relating to the provisioning for Islamic banks should be clearly laid down, fully identifying provisions relating to assets financed by own funds and those by the investment account holders; and
- (g) Facilities should, at minimum, include four categories along the following lines:
 - (i) *'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);
 - (ii) *'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;
 - (iii) *'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;
 - (iv) *'Loss credits'* are considered uncollectible 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 affected in the future.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

CM-3.3 Impairment of assets and provisioning

Impairment of assets

CM-3.3.1 Banks are required to place on a non-accrual basis any facility where there is reasonable doubt about the collectability of the receivable irrespective of whether the customer concerned is currently in arrears or not. This acknowledges the reality that recognition of impaired assets will have a high degree of subjectivity attached to it.

CM-3.3.2 Impaired assets should be classified into one of the following categories:

- (a) Non accrual items;
- (b) Restructured items; or
- (c) Other assets acquired through security enforcement, including 'other real estate owned'.

CM-3.3.3 For the purpose of this Module, The following definition of non-accrual items applies:

- (a) Financing facilities and investments where there is reasonable doubt about the ultimate collectability of principal within a time frame established by the bank. Non-accruals would include all facilities against which a specific provision has been established, or a write-off taken even if the facility is not in breach of contractual requirements. Refer to AAOIFI's FAS 11 on recognition of provisions and reserves.
- (b) Financing facilities and investments, not included in (a), where contractual payments of the principal are 90 or more consecutive days in arrears, and where the 'fair value' of security is insufficient to cover repayment. In line with the principles outlined above, a facility should be classified as non-accruing earlier than 90 days where it is evident that full, or partial repayment of the amount is unlikely even though the full extent of the loss cannot be clearly determined.



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CHAPTER	CM-3: Assessment of credit quality

Provisioning

CM-3.3.4 Banks must maintain an adequate level of provisioning against the impairment of assets and problem exposures if their earnings and capital adequacy are to be measured correctly.

CM-3.3.5 As a general rule, where there is a doubt about the collectability of a receivable, and security exists, provisions should equal the carrying value of the receivable less the net current market value of security.

CM-3.3.6 Provisions of either type (specific or general) are made in relation to receivables, financing and investment assets in cases where there is doubt regarding collectability or an impairment of value. Refer to AAOIFI's FAS 11: Provisions and Reserves.

CM-3.3.7 Provisioning should be carried in the respective books including bank's own books, unrestricted investment account holders' books and restricted investment account holders' books.

CM-3.3.8 A general provision is an amount set aside to reflect a potential loss that may occur as a result of currently unidentifiable risks in relation to receivables, financing or investment assets. The amount reflects estimated losses affecting these assets attributable to events that have already occurred at the date of the statement of financial position, and not estimated losses attributable to future events.

CM-3.3.9 The policy for provisioning should clearly contain provisions for segregating provisions relating to assets financed by own funds and those financed by investment account holders. In devising the policy, reference should be made to the Mudaraba contract.

CM-3.3.10 A specific provision is an amount set aside to reflect an estimated impairment of value of a specific type of asset. In the cases of investment assets, it is the amount needed to write the assets down to cash equivalent value if this is lower than cost. Refer to AAOIFI's FAS 11: Provisions and Reserves.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

CM-3.4 Provisions against sovereign credit

CM-3.4.1 The Central Bank has consistently encouraged banks to maintain adequate provisions against credits to borrowers experiencing difficulties and against credits for countries with current or potential credit servicing difficulties.

CM-3.4.2 In all cases the assessment of credits - and decisions regarding adequate provisions - are assisted by the categorization of credits as defined by the Central Bank in Section CM-3.2. In addition, with regard to 'sovereign credit' 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 credits. With these objectives in mind, the Sovereign Credit 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-3.4.3 It is emphasized that this Section and the Sovereign Credit 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 Credit Provisioning Matrix

CM-3.4.4 The banks should continue to apply the Sovereign Credit 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3: Assessment of credit quality

CM-3.5 Collateral

CM-3.5.1 The extension of credit is often supported by collateral provided by the customer or third parties. When the credit decision is based on collateral value, independent timely appraisals of the collateral should be obligatory, including provision for sufficient security margins.

CM-3.5.2 In principle, collateral can improve the credit grading of a customer, but experience suggests that over-reliance on collateral is unsound because very often when a credit facility goes sour the collateral turns out to have less value than estimated or is, at worst, illusory.

CM-3.5.3 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-3.5.4 As a matter of principle, collateral should not replace a careful assessment of the borrower's ability to repay.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.1 Overview

CM-4.1.1 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-4.1.2 The contents of this Chapter apply in full to all locally incorporated Islamic banks in the Kingdom of Bahrain.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.2 The measure of exposure

CM-4.2.1

The measure of exposure reflects the maximum loss should a counterparty fail, or loss that may be experienced due to non-repayment of facilities granted. Consistent with this, an exposure encompasses 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;
- (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;
- (c) Holdings of equity capital, sukuks 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; and
- (d) Other assets (whether on balance sheet or restricted investment accounts), which constitute a claim for the bank and its customers and which are not included in (a) or (b) above. In particular, exposures where the bank itself is not exposed, but is committing client funds such as restricted investment accounts are included here.

CM-4.2.2

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 where they relate to the same customer or to corporate customers in the same business group if:

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



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

For a group facility, a full cross guarantee structure must also exist (i.e. full multilateral guarantees must be in place between all the companies within the group).

CM-4.2.3

Large exposures are calculated using the sum of the nominal amounts before the application of the 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.

CM-4.2.4

In case of syndicated facilities, the nominal amount would include only the bank's share of the syndication (financed by unrestricted investment accounts and bank's own funds) and any amounts for which binding commitments from other financial institutions are not available. Where a binding commitment is available, that amount would be excluded in calculation of the large exposures. See Section CM-4.5 for exemptions.

CM-4.2.5

For the purpose of large exposures, balance sheet claims involving assets acquired to be leased under Ijarah Muntahia Bittamleek should be reflected as an exposure against the lessee. Further, murabaha contracts where assets are held for resale, under a binding promise, such exposure should be reflected as an exposure to the counterparty which has signed the binding promise. Potential claims in the case of Istisna'a contracts should include the total amount expected to be paid to al-Sani (the seller) and shown as an exposure to al-Mustasni (ultimate buyer).

CM-4.2.6

A bank's exposure arising from securities' trading operations is calculated as its net long position in a particular security. A bank's 'net position' in a security refers to its commitments to buy that security together with its current holding of the same security, less its commitments to sell such a security.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.3 Identity of counterparty

CM-4.3.1 For the purposes of measuring exposures, the counterparty will generally be the customer receiving the funds, the person guaranteed, and the issuer of a security in the case of a security held.

CM-4.3.2 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 guarantor, rather than the person guaranteed.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.4 Limits for large exposures

Aggregate limit on large exposures

CM-4.4.1 A 'large exposure' is any exposure whether direct, indirect or funded by restricted investment accounts to a counterparty or a group of closely related counterparties which is greater than, or equal to, 10% of the reporting bank's (consolidated) capital base.

CM-4.4.2 'Capital base' is the adjusted capital base for the purpose of the risk asset ratio calculated in accordance with the PIRI return (see Module BR) (or owner's equity) using the most recent annual consolidated balance sheet, subject to any specific requirements by the Central Bank.

CM-4.4.3 The aggregate of large exposures (from both on-balance sheet and restricted investment accounts) may not exceed 1200% of the bank's (consolidated) capital base whether funded or not funded, i.e. contingent commitments.

CM-4.4.4 However, the aggregate of large exposures from on-balance sheet exposures should not exceed 800% of the bank's (consolidated) capital base whether funded or not funded.

Single exposure limit

CM-4.4.5 The following single exposure limits apply:

- (a) *Direct exposures (i.e. funded by a bank's own funds or unrestricted investment accounts):* 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 without the prior written approval of the Central Bank. For this purpose, companies/banks with variable capital should not include participation shares in calculating their capital base, since there are governed by Mudaraba contract (profit sharing).



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

- (b) *Restricted investment accounts:* A bank may not incur an exposure to an individual counterparty or group of closely related counterparties where the exposure is funded by restricted investment accounts, which exceeds 30% of the reporting bank's (consolidated) capital base.
- (c) *The combined exposures:* A combined exposure of (a) & (b) above (funded by unrestricted investment accounts, or a bank's own funds or restricted investment accounts) to an individual counterparty or group of closely related parties may not exceed 35% of the reporting bank's (consolidated) capital base.

Closely related counterparties

CM-4.4.6

Closely related counterparties are two or more counterparties who constitute a single risk because one of them has, direct or indirect, 'control' over the other(s) (see below) 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-4.4.7

'Control' means either significant ownership (i.e. ownership of 20% or more of voting equity) 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.

Limit on exposures to connected counterparties

CM-4.4.8

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 policy statement agreed with the Central Bank.

CM-4.4.9

No Islamic facilities provided by a bank to its own external auditors shall be permitted. In addition, unless provided for in the contract, off-balance sheet restricted investment accounts will not be permitted to participate in on-balance sheet corporate funding and vice versa and movement within restricted investment accounts is not permitted without the Central Bank's prior written approval.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.4.10 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 holding less than 10% of the share capital of the bank (whether such association is due to control or family links or otherwise), members of the Shari’a Supervisory Board, senior management and other staff, and shareholders (and their appointed board representatives) holding 10% or more of the voting power of the bank (see CM-4.4.13 below). In this context, family links means spouse, father, mother, sons, daughters, sisters and brothers.

CM-4.4.11 The Central Bank will closely examine 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-4.4.12 Lending to senior management is covered under Chapter CM-5. All credit facilities to senior management will be included under the limits given in the table under paragraph CM-4.4.14.

Limit on exposures to shareholders

CM-4.4.13 Shareholders with significant ownership of the bank's capital (i.e. 10% and above) are not allowed to obtain financing facilities from the bank (i.e. a 0% limit), however smaller shareholders will be subject to the normal exposure limits outlined in CM-4.4.5. Directors who are also shareholders (or their appointed board representatives) with significant ownership (i.e. above 10% or above) are subject to the 0% limit mentioned above.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.4.14 The limits for connected counterparties have been set as follows:

Connected Counterparties	Individual Limit	Aggregate Limit
Shareholders with 'significant ownership' (mentioned in CM-4.4.13)	0%	0%
Other connected Counterparties (mentioned in CM-4.4.10)	Individual Limit	Aggregate Limit
Direct exposures	A bank may not incur an exposure (whether funded or not funded) to an individual connected counterparty (as defined above) which exceeds 15% of the reporting bank's (consolidated) capital base. (a)	The aggregate exposures to all counterparties within this category should not exceed 25% of the bank's consolidated capital base. (c)
Restricted investment accounts	A bank may not incur an exposure (whether funded or not funded) to an individual connected counterparty where the exposure is funded by restricted investment accounts which exceeds 25% of the reporting bank's (consolidated) capital base. (b)	The aggregate exposures to all counterparties within this category should not exceed 35% of the bank's consolidated capital base. (d)
The combined exposures	A combined exposure of (a) & (b) above (funded by unrestricted investment accounts and bank's own funds, and restricted investment accounts) whether funded or not funded, to an individual connected counterparty may not exceed 25% of the reporting bank's (consolidated) capital base.	The aggregate exposures of: (c) and (d) above (whether funded from on balance sheet or restricted investment accounts) may not exceed 60% of the bank's (consolidated) capital base, whether funded or not funded.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.5 Exempt exposures

CM-4.5.1 Certain types of exposure are exempt from the limits set out above, but notification of such exposures should be made to the CBB Bank.

CM-4.5.2 These exemptions fall into the following categories and are subject, in each case, to the policy statement as agreed with the CBB:

- (a) Islamic bonds/ Sukook issued or guaranteed by the Government of Bahrain or its Agencies;
- (b) Islamic bonds/ Sukook issued or guaranteed by the IDB;
- (c) Short term (one year or less) interbank exposures;
- (d) Exposures to GCC governments, and their Public Sector Entities that do not operate on commercial basis;
- (e) Exposures to OECD central governments;
- (f) Exposures secured on cash or GCC government securities/guarantees;
- (g) Exposures secured on OECD central government securities/guarantees;
- (h) Certain connected exposures, in particular those arising from a group treasury function;
- (i) Exposures which are covered by a guarantee from the bank's parent (see Paragraph CM-4.5.8);
- (j) Exposures arising from underwriting activities, such exposures continuing for no more than 90 calendar days. Any residual holdings of securities for more than 90 days from the commitment date of underwriting are no longer exempt and would be subject to normal large exposure limits;
- (k) Exposures where the bank is acting as agent for an investor in a single purpose, non-discretionary capacity, and the bank has the full right to set-off losses and costs against any funds provided by the investor (examples might include real estate investments); and
- (l) Syndicated facilities being financed by restricted investment accounts where the investor is fully aware of the type of investment and the associated risks.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

Exempt exposures to connected counterparties

CM-4.5.3 In respect of exposures to other group companies, the Central Bank's policy allows 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-4.5.4 In certain exceptional cases, exposures of more than 15% of (consolidated) capital base to a bank which controls the financing bank may be permitted for utilisation of surplus liquid funds for a short period not exceeding 90 days even where the financing bank does not perform a treasury role. Any other form of connected financing outside the scope of the above will be dealt with by the Central Bank on a case-by-case basis.

Exposures undertaken by a subsidiary bank or by a branch outside Bahrain

CM-4.5.5 In the case of banks, which are the Bahrain subsidiaries of overseas banks, the Central Bank will agree in writing with the supervisory authority of the parent bank, the size of exposures that can be undertaken by the subsidiary.

CM-4.5.6 Exposures undertaken by a branch of a foreign bank on the books in Bahrain should be within the policy statement of the parent bank (company) as agreed by the parent's regulatory authority.

CM-4.5.7 Overseas subsidiaries of Bahrain banks will be expected to comply with the regulatory requirements of the country in which they are located.

CM-4.5.8 Where exposures undertaken by a subsidiary bank are guaranteed by its parent, the subsidiary bank may be deemed to have an exposure to the parent.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.5.9 Under the terms of this Module, 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 non-performing or require to be written off.

CM-4.5.10 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 for the subsidiary, the Bahrain parent must at all times have room to take over the exposure, without itself exceeding the limit of 15% of capital base. Also, the combined (on- and off-balance sheet) exposure of the banking group to the customer must be within 35% of the parent bank's consolidated capital base.

CM-4.5.11 The Central Bank will need to be satisfied that adequate control systems are in place to ensure that credit risk taken in the group as a whole is properly monitored and controlled.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.6 Reporting of exposures

CM-4.6.1 Bahrain incorporated banks are required to report all large exposures on a quarterly basis using the PIRI return provided in Appendix BR-4.

CM-4.6.2 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-4.6.3 For some banks, the Central Bank may determine it prudent to set a lower percentage(s) than the ones given herein.

CM-4.6.4 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.7 Policy statements

CM-4.7.1 The Central Bank requires each bank incorporated in Bahrain to set out its policy and internal limits on large exposures, including exposures to individual customers, banks, institutions, countries and economic sectors, in a policy statement which should be formally adopted by the Board of Directors. The policy statement should be part of the risk management policy of the bank. The Central Bank expects banks not to implement significant changes in these policies without prior discussion with the Central Bank.

CM-4.7.2 Each bank should discuss their policy statement with the Central Bank. Each bank will be expected to justify to the Central Bank its policy on exposures to individual counterparties, including the maximum size of an exposure contemplated.

CM-4.7.3 Exposures to counterparties connected with the bank will continue to be particularly closely examined.

CM-4.7.4 The necessary control systems to give effect to a bank's policy on large exposures should be clearly specified and monitored by its Board.



MODULE	CM: Credit Risk Management
CHAPTER	CM-4: The monitoring and control of large exposures of banks licensed by the Central Bank

CM-4.8 Concentrations in economic and market sectors

CM-4.8.1 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-4.8.2 Concentrations should also be recognized 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-4.8.3 Banks must specify in their policy statements how they define economic and market sectors, and what limits apply to differing sectors.

CM-4.8.4 Exposures and limits for sectors should be reviewed at least quarterly by the Board of Directors.

CM-4.8.5 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-5: Staff credit facilities

CM-5.1 Reporting and compliance

CM-5.1.1 The Central Bank's prior written consent should be obtained for any credit facilities provided to an employee where the amount of such facility, either singly or when added to an existing facility/existing facilities outstanding to that employee at that date, would be equal to or in excess of BD 100,000 (Bahrain Dinars One Hundred Thousand), 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-5.1.2 Banks must ensure that the provisions of relevant laws (including, specifically, the Bahrain Labour Law) are observed at all times in this area.



MODULE	CM: Credit Risk Management
CHAPTER	CM-6: Write-off – Credit facility

CM-6.1 Write-offs

CM-6.1.1 All locally incorporated banks, should notify the Central Bank of any write-off of a credit facility, (i.e. Murabaha or any other credit facility) of an amount in excess of BD 100,000 (Bahrain Dinars One Hundred Thousand), or its equivalent in foreign currency.

CM-6.1.2 Such notification should be accompanied with documentary evidence showing, beyond reasonable doubt, that the customer does not possess the resources to fulfil the outstanding obligation.

CM-6.1.3 Banks should also obtain the CBB's prior written approval before writing off any of their following claims:

- (a) claims on present or former Directors of the bank;
- (b) claims which are guaranteed by a Director of the bank;
- (c) claims on any business entity for which the bank or any of its Directors is an agent;
- (d) claims on any officer or employee of the bank, or any other person who receives remuneration from the bank;
- (e) claims on 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) claims on any person who is a Director, manager or officer of another bank licensed by the Central Bank.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.1 Overview

CM-7.1.1 This Chapter sets out various requirements regarding the provision of consumer finance within the Kingdom of Bahrain by CBB licensees. The aim of these requirements is to encourage:

- (a) prudent provision of credit facilities 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-7.1.2 The contents of this Chapter apply 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 Islamic 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.2 The Central Bank's approach to consumer finance

CM-7.2.1 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-7.2.2 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 clearly to display and communicate charges and profit rates (see, for instance, Section BC-4.3).

CM-7.2.3 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-7.2.4 The measures presented in this Chapter should be viewed as minimum standards, rather than best practice. They are aimed to encouraging prudent extension of credit facilities and full, frank and fair disclosures, rather than dictate 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-7.2.5 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-7.2.6 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-7.2.7 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 financing practices and disclosure standards.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.3 Definition of Consumer Finance

CM-7.3.1 Consumer finance is the provision of any form of credit facility to an individual excluding:

- (a) any credit facility secured by a first charge on residential property to an individual, where the counterparty 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 counterparty.

CM-7.3.2 For the purposes of the Rulebook, 'credit facility' includes personal overdraft facilities, credit cards, ijara or other financing facility.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.4 Maximum limits

Total repayments ratio

- CM-7.4.1** Licensees may only provide a new consumer facility (or renew, extend or otherwise modify an existing consumer facility) for an amount such that the counterparty'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 Paragraph CM-7.4.6 and CM-7.4.10.
- CM-7.4.2** 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-7.4.3** 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-7.4.4** 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-7.4.5** When factoring in credit cards into the repayment limit in Paragraph CM-7.4.1 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.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.4.6 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-7.4.4 above and is satisfied that the counterparty can comfortably support a higher facility service ratio.

CM-7.4.7 The review undertaken to satisfy requirements in Paragraph CM-7.4.4 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-7.4.8 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-7.4.9 The Central Bank does not believe it prudent for licensees to encourage the provision of credit facilities 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-7.4.10 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-7.4.1. Such facilities must also be identified as 'technically non compliant'. Banks must report all 'technically non-compliant facilities' to the Director of Islamic Financial Institutions Supervision Directorate on a quarterly basis.



MODULE	CM: Credit Risk Management
CHAPTER	CM-7: Consumer finance

CM-7.5 Disclosure requirements

Disclosure of key terms

CM-7.5.1 Licensees must make clear to potential counterparties, 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-7.5.2 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 counterparties (in duplicate) as having been read and understood, prior to signing a consumer finance agreement. One copy should be retained by the counterparty and the other must be retained by the licensee in their customer file.

CM-7.5.3 The ‘key terms disclosure’ document must, amongst other things, make clear:

- (a) the amount being received or the credit limit being offered, its maturity and repayment schedules;
- (b) the nominal amount of the cost of credit to be provided to the customer;
- (c) whether this cost of credit is fixed or can go up and / or down, and under what circumstances;
- (d) the basis on which the cost of credit is calculated and when capital repayments are taken into account in the calculation, together with an illustration of the calculation method;
- (e) a breakdown of all other costs not included in (b), (c) and (d) above and associated with the credit, such as arrangement fees, documentation fees, late payment fees (if permitted by the Shari’a Board, and obligatory payment protection insurance costs;
- (f) the full costs associated with top-ups of installment facilities or early repayments of amounts due (in full or in part if permitted by the Shari’a Board), including the treatment of remaining profit and the payment of premium for insurance; and
- (g) the Profit Rate, as defined in Paragraph CM-7.5.5 below.



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CM-7.5.4

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-7.5.3 above. CBB will monitor compliance with the spirit as well as the letter of the requirements in this Chapter. If necessary, CBB will consider prescribing a standard template to be used by all licensees engaged in consumer finance.

Annual Profit Rate ('APR')

CM-7.5.5

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 premium.

CM-7.5.6

The APR should be shown clearly on the facility document and 'key terms disclosure' document (as set out in Paragraphs CM-7.5.1 to CM-7.5.4 above).

CM-7.5.7

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-7.5.8

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

- (a) Effective rate of profit on the credit;
- (b) Documentation or administration fees;
- (c) In the case of ijara or deferred purchase 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-7.5.9 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-7.5.10 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_k** is the amount of advance K;
- A'_{k'}** is the amount of instalment K';
- \sum represents the sum of all the terms indicated;
- M** is the number of advances of credit;
- M'** is the total number of instalments;
- t_k** is the interval, expressed in years between the relevant date and the date of advance K;
- t'_{k'}** 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-7.5.11 For the purpose of this Chapter, the 'relevant date' is the earliest identifiable date on which the customer 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-7.5.12 In the case of instalment finance such as a credit facility, where there is no reimbursement of cost of credit in the event of early repayment, then the residual cost of credit in the old facility must be added to the cost of credit for the new facility, and the APR amended accordingly.



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CM-7.6 Refunds and Prepayments

Refund/ Adjustment of Insurance Premium on Financing Prepayments and Top-Ups

CM-7.6.1 Banks/financing companies must refund/adjust proportionately the insurance premium charged on individual credit facilities when the customer either requests for a top up or prepayment of the credit facility as per the prescribed formula below:

$$\text{Refund/Adjustment Amount} = \frac{\text{Remaining period to Maturity} \times \text{Premium Paid}}{\text{Original Maturity}}$$

Early Repayment fees/Charges

CM-7.6.2 The CBB imposes a ceiling on the early repayment charges on consumer and mortgage credit facilities as follows:-

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



MODULE	CM: Credit Risk Management
CHAPTER	CM-8: Islamic contracts

CM-8.1 Overview

CM-8.1.1 The Central Bank recognises the unique risk characteristics of Islamic contracts,

CM-8.1.2 which may have implication on the asset quality of a bank.

CM-8.1.3 In order to monitor and identify any asset deterioration due to the Islamic contracts, the Central Bank requires additional disclosures (see Module BR) on the Islamic contracts undertaken by the bank during the period.

CM-8.1.4 Definitions, disclosure requirements and method(s) of accounting treatments for some of the Islamic contracts are outlined below.

Murabaha

CM-8.1.5 Revenue for the purpose of Murabaha contracts must be recognised on an accrual basis.

CM-8.1.6 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFI's FAS 2: Murabaha and Murabaha to the Purchase Orderer.

Mudaraba

CM-8.1.7 Revenue on Mudaraba contracts may only be recognised to the extent it is being distributed.

CM-8.1.8 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFI's FAS 3: Mudaraba Financing.

CM-8.1.9 As part of its on-going supervision of Islamic banks, the Central Bank has set out the type of terms and conditions (see Appendix BC-7) which it believes Islamic banks should include, as a minimum, in such contracts.

Musharaka

CM-8.1.10 Under a Musharaka contract, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.



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Musharaka (continued)

CM-8.1.11 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFT's FAS 4: Musharaka Financing.

Salam

CM-8.1.12 As a policy no Salam contracts should be entered into without covering the position through a Parallel Salam contract.

CM-8.1.13 Where the bank is not able to enter into a Parallel Salam contract it must agree a statement policy with the Central Bank.

CM-8.1.14 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFT's FAS 7: Salam and Parallel Salam.

Istisna'a

CM-8.1.15 As a policy no Istisna'a contracts should be entered without covering the position through a Parallel Istisna'a contract.

CM-8.1.16 In accordance with provisions contained in FAS 10: Istisna'a and Parallel Istisna'a, revenue and profit on such contracts should be recognised on a percentage of completion method.

CM-8.1.17 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFT's FAS 10: Istisna'a and Parallel Istisna'a.

Ijarah and Ijarah Muntahia Bittamleek

CM-1.1.18 For a detailed definition, disclosure requirements and method(s) of accounting treatment, refer to AAOIFT's FAS 8: Ijarah and Ijarah Muntahia Bittamleek.

Facilities transferred to Qard Hassan

CM-8.1.19 The Central Bank's approval should be obtained before any transfer of any exposures to Qard Hassan if the amount is more than BD 100,000 or its equivalent in foreign currency.

CM-8.1.20 The requirement stated in Paragraph CM-9.1.1 above applies to both on-balance sheet and restricted investment account related exposures.