



# **CREDIT RISK MANAGEMENT MODULE**



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## CM-A.1 Purpose

### *Executive Summary*

CM-A.1.1 The purpose of this Module is to provide the Central Bank of Bahrain's (CBB's) Directive concerning requirements relevant to the key elements of a sound credit risk management system which it expects conventional bank licensees to observe.

CM-A.1.2 This Module must be read in conjunction with other parts of the Rulebook, mainly:

- High-level Controls;
- Capital Adequacy;
- Liquidity Risk;
- Operational Risk;
- Interest Rate Risk in the Banking Book;
- Reputational Risk;
- Credit Risk;
- Stress Testing; and
- Internal Capital Adequacy Assessment Process ('ICAAP').

### *Legal Basis*

#### CM-A.1.3

This Module contains the CBB's Directive (as amended from time-to-time) relating to credit risk management in conventional bank licensees and is issued under powers available to the CBB under Article 38 of the of the Central Bank of Bahrain and Financial Institutions Law (Decree No. 64 of 2006) ("CBB Law"). This Module is applicable to all conventional bank licensees. Branches of foreign bank licensees shall comply with the requirements in this Module unless stated otherwise under relevant paragraphs of the Module.

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 Module History

CM-A.2.1 This Module was first issued in July 2004. Changes made subsequently to this Module are annotated with the calendar quarter date in which the change was made as detailed in the table below. Chapter UG 3 provides further details on Rulebook maintenance and version control.

### *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-5	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-3.1	04/2008	Guidance concerning material interest as shareholder for write-offs.
CM-5.6	04/2008	New Refund and prepayment requirements.
CM-2.7	10/2009	New reporting arrangements for <u>exposures</u> of connected <u>counterparties</u> .
CM-2.7	01/2010	Revised reference for LE reporting.
CM-A.1.3	01/2011	Clarified legal basis.
CM-5	01/2011	Changes made to incorporate Basel Core Principle 5 and new large <u>exposure</u> requirements along with a consistency alignment of Volume One and Volume Two.
CM-A.1.1, CM-A.2.4	04/2011	Corrected typo.
CM-2.3.1(c), CM-2.6.1	04/2011	Corrected cross reference.
CM	07/2011	Various minor amendments to clarify Rules and have consistent language.
CM-2.5.9	07/2011	Amended the definition of connected <u>counterparties</u> .
CM-5.5.9 and CM-5.5.10	10/2011	Corrected elements of APR formula.
CM-5.5.12	10/2011	Paragraph deleted as it does not reflect current practice on residual interest.
CM-2.5.1.E	01/2012	Amended definition of qualifying holdings.
CM-2.6	01/2012	Clarified and amended the Rules on temporary exposures.
CM-2.10.3	01/2012	Clarified the Rule on future increases in qualifying holdings.
CM-5.4.9	01/2012	Changed Rule to Guidance.
CM-2.6.2	04/2012	Clarified Rules on temporary exposures.
CM-A.2.8	07/2012	Updated reference to Bahrain Association of Banks.
CM-2.5.6	07/2012	Clarified the definition of 'controlling interest'.
CM-2.5.7A	07/2011	CBB prior approval required for excess over limits to connected <u>counterparties</u> .
CM-2.5.9	07/2012	Minor correction.
CM-2.10.3	07/2012	Amendment made to be in line with updated definition of qualifying holdings.
CM-5.5.4	07/2012	Minor typo corrected.
CM-5.5	10/2012	This Section was deleted and requirements are now included in Section BC-4.3.
CM-A.2.10	01/2013	Clarified Rule related to the write-off of a credit facility.



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## CM-A.2 Module History

CM-A.2.2 (continued)

### *Summary of Changes*

Module Ref.	Change Date	Description of Changes
CM-2.5.11	07/2013	Clarified Rule on the amount that must be deducted from the capital base where exposure exceeds the limit stipulated.
CM-5.6.2	07/2013	Clarified the type of mortgages on which the CBB imposes a ceiling on early repayment fees and/or charges.
CM-1.2.4	10/2013	Amended to reflect the expanded scope of activities of the Credit Reference Bureau and the membership requirements.
CM-5.4.4	10/2013	Updated reference to Eskan Bank to reflect new name.
CM-1.2.4	01/2014	Clarified Rule to apply to credit facilities to residents in Bahrain.
CM-A.2, CM-4.3 and CM-5	04/2014	Added cross references and corrected terminology to link to Glossary terms.
CM-6.1	04/2014	Clarified Rules on staff loan s.
CM-5.2.4	04/2014	Reference updated for the code of best practice on consumer credit and charging.
CM-2.10.2A	07/2014	Added a guidance Paragraph to clarify the treatment of investments in commercial entities which are otherwise not connected to the bank.
CM-A.2 and CM-5	01/2015	Corrected to be aligned with updated requirements under Module CA.
CM-2.3.2	01/2015	Added reference to transactions subject to the Regulation on close-out netting under a market contract.
CM-2.5.1B	01/2015	Corrected cross reference.
CM-2.5.1E	04/2015	Deleted cross reference as not applicable.
CM-2.6.2B and CM-2.10.10	04/2015	Corrected reference to consolidated total capital to be in line with Module CA.
CM-2.7.1	04/2015	Added reference to Appendix BR-19 for reporting the financial details of each large exposure.
CM-2.10.3	04/2015	Clarified language on the treatment of significant investments over the thresholds outlined in Paragraph CA-2.4.25.
CM-2.7.1, CM-2.7.1A and CM-2.7.1B	07/2015	Clarified the reporting requirements of exposures.
CM-2.5.11	10/2015	Clarified limits on large exposures.
CM-3.1	10/2015	Amended Rules on write-offs.
CM-2.5.1E	10/2016	Amended definition of major investment.
CM-2.5.3	10/2016	Added 'Limits to Significant Investments' new Section reference.
CM-2.10.2	10/2016	Major investments defined.
CM-2.10.2A	10/2016	Paragraph moved to CM-2.11.4.
CM-2.10.3	10/2016	Amended and split into CM-2.10.3 A, B, C and D.
CM-2.10.3D	10/2016	Amended Rule.
CM-2.10.6	10/2016	Moved to new section 5.11.
CM-2.10.7	10/2016	Moved to new section 5.11.
CM-2.10.8	10/2016	Moved to new section 5.11.
CM-2.10.10	10/2016	Amended 'Acquisitions' to be 'Investments'.
CM-2.11	10/2016	New Section 'Limits on Significant Investments'.
CM-3.1.1	10/2016	Amended the Write-offs Section.
CM-5.4.5	10/2016	Amendments to clarify the Rule.
CM-A2.2A CM-2.5.3A	01/2017	Added a new requirement on Large Exposures.
CM-2.5.5A CM-2.5.9B	01/2017	Added Paragraphs on closely related counterparties and connected counterparties.
CM-4.5	07/2017	Added new Section on 'Country and Transfer Risks'.
CM-8.6.2	04/2018	Deleted Paragraph on "Early Repayment Fees/Charges".
CM-8.4.10	10/2019	Amended Paragraph on non-compliant facilities.
CM-5.6.2D	01/2020	Amended Paragraph on approval of the banks policies and procedures.
CM-1.2.6	07/2020	Added a new Paragraph on CRB members requirements.
CM-1.2.7	07/2020	Added a new Paragraph on compliance with CBB Law.
<b>Full Module CM</b>	<b>07/2021</b>	<b>Revised CM Module to incorporate various changes in qualitative requirements in line with Basel Committee on Banking Supervision standards and best practices</b>



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## CM-A.2 Module History (Continued)

### *Effective Date*

#### CM-A.2.3

The requirements in this amended Module are effective from 30<sup>th</sup> June 2022 on which date the existing Module CM will become redundant and any exemptions allowed under the existing Module will be subject to grandfathering requirements with the approval of CBB.



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<b>CHAPTER</b>	<b>CM-1</b>	<b>Credit Risk Management Requirements</b>

## CM-1.1 Overview

- CM-1.1.1 Credit risk is the likelihood that a counterparty of the licensee 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 licensee'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 The effective management of credit risk is a critical component of a comprehensive approach to risk management and is essential to the long-term success of any banking organisation.
- 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 licensee should be monitored by a Credit Committee, composed of officers with adequate seniority and experience.
- CM-1.1.4 Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program shall specifically address the following areas (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.





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CHAPTER	CM-1	Credit Risk Management Requirements

## CM-1.2 Credit Risk Management Framework

**CM-1.2.1** Conventional bank licensees must establish a credit risk management unit (CRMU) within their organisational structure which will be responsible for identification, assessment, measurement, monitoring and controlling of credit risk inherent in the entire credit portfolios, as well as credit risk in individual credit exposures. The credit risk management framework must consider the relationship between credit risk and other risks.

**CM-1.2.2** The CRMU must be independent and must ensure that it undertakes the credit risk management activities with no influence from business functions responsible for credit underwriting.

CM-1.2.3 The CRMU should not have management or financial responsibility related to credit operational business line or revenue generating functions.

### *The Role of the Board of Directors*

**CM-1.2.4** The Board of Directors of the conventional bank licensee is responsible for ensuring that the licensee has an effective CRMU and for approving and regularly reviewing, at least every two years, its credit risk policies, credit risk appetite and limits framework. Amendments made to such documents must also be approved by the Board. The Board may delegate some of its functions, such as approval of policies, amendments to policies and periodic reviews to a designated Board committee.

CM-1.2.5 Effective credit risk management is imperative to optimise the licensee's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. A risk appetite statement is a written articulation of the aggregated level and types of risk exposures that the licensee will accept, or avoid, in order to achieve its business objectives.

**CM-1.2.6** The Board must ensure that the credit risk policies cover all activities of the conventional bank licensee in which it incurs credit risk. The Board must also determine that the licensee's capital level is adequate for the risks assumed throughout the entire organisation or group.

**CM-1.2.7** The credit risk policy must document the licensee's willingness to grant credit based on exposure type (commercial, consumer, real estate etc.), economic sector, geographical location, product, currency, maturity and anticipated profitability. This might also include the identification of target markets and the overall characteristics that the conventional bank licensee would want to achieve in its credit portfolio (including levels of diversification and concentration tolerances).



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## CM-1.2 Credit Risk Management Framework (Continued)

**CM-1.2.8** The Board must ensure that the credit risk appetite framework delineates the delegated powers, lines of responsibility and accountability over credit risk management decisions, and must clearly define authorised instruments, hedging strategies and risk-taking opportunities.

**CM-1.2.9** The Board must assess whether the conventional bank licensee is operating within the boundaries of the credit risk appetite and limits framework approved by the Board.

**CM-1.2.10** The Board must ensure that it receives adequate management information reports and exception reports to meet its oversight requirements to monitor adherence to the licensee's risk tolerance/appetite/limits. The Board must regularly evaluate whether it is receiving the right balance of detail and quantitative versus qualitative information.

**CM-1.2.11** The Board must approve the structure in which the conventional bank licensee will organise its credit-granting functions, including independent review of the credit granting process and the overall portfolio.

CM-1.2.12 For branches of foreign bank licensees where no Board/Audit Committee exists, all references to the Board/Audit Committee should be interpreted as the Group Chief Risk Officer or equivalent person who has direct access or reports to the Board or Audit Committee of the parent bank, unless alternative structures that satisfy the primary objectives of such oversight are in place.

### *The Role of the Senior Management*

**CM-1.2.13** Senior management of the conventional bank licensee is responsible for developing, implementing and approving sound credit risk procedures in accordance with credit risk policies approved by the Board.

**CM-1.2.14** Senior management must determine that the staff involved in any credit relationship, whether established or new, basic or complex, have the necessary knowledge, skill sets, experience and are fully capable of ensuring the relationship meets the highest standards and in compliance with the licensee's policies and procedures.

**CM-1.2.15** Senior management must ensure that risk monitoring systems are in place for effectively undertaking the activities of credit risk management.



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## CM-1.2 Credit Risk Management Framework (Continued)

### *Credit Risk Policy and Procedures*

CM-1.2.16 A properly documented credit risk policy is an essential element of, and a prerequisite for, the credit risk management process. Consistent with the Board's objectives, it assists licensee's management in the maintenance of proper credit standards and the avoidance of unnecessary risks. Additionally, periodic internal assessment should be undertaken by the internal audit. In the case of branches of foreign banks, the credit policy, limits and the procedures are normally those that are approved by the Head Office/Regional Office.

**CM-1.2.17** **Senior management, based on the approved credit risk policy, must develop credit risk procedures for identifying, measuring, monitoring and controlling credit risk. The procedures must address credit risk in all of the conventional bank licensee's activities, and at both the individual credit and portfolio levels.**

CM-1.2.18 Explicit guidelines in the credit risk policy provide the basis for effective credit risk management. A sound credit risk policy should consider which types of credit products and borrowers the licensee is looking for, and the underwriting standards the licensee will utilize.

**CM-1.2.19** **Conventional bank licensee's credit risk framework must address all credit and credit risk related activities throughout the credit lifecycle covering matters of significance including, but not limited to:**

- (a) Organisation and reporting structure of the credit risk function/activities;**
- (b) Delegation of authority;**
- (c) Role of credit committee and Board risk committee;**
- (d) Designated markets and products;**
- (e) Credit limit framework;**
- (f) Desirable pricing levels and criteria;**
- (g) Policy on country and transfer risks;**
- (h) Credit granting criteria and authorisation procedures for the advancement of credit, including exceptions to set criteria and limits;**
- (i) Credit risk analysis, reviews and credit risk ratings;**
- (j) Assessment of concentration;**
- (k) Large exposure policy;**
- (l) Lending to connected counterparties;**
- (m) Problem credit identification, remediation and administration;**
- (n) Policies and procedures on write-offs and recoveries;**
- (o) Monitoring and reporting.**



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CHAPTER	CM-1	Credit Risk Management Requirements

## CM-1.2 Credit Risk Management Framework (Continued)

### CM-1.2.20

Conventional bank licensees must operate within sound, well-defined credit-granting criteria. These criteria must include a clear indication of the licensee's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit and its source of repayment. In addition, the criteria must set out who is eligible for credit and for how much, what types of credit are available, and under what terms and conditions the credit may be granted.

CM-1.2.21 In the case of branches of foreign bank licensees, the credit policies, credit limits and the procedures are those that are approved by the Head Office/Regional office.

### *Effectiveness of Internal Control System*

### CM-1.2.22

An effective internal control system for credit risk assessment and measurement is essential to enable senior management to carry out its duties. An effective internal control system must include:

- (a) Measures to comply with applicable laws, regulations and internal policies and procedures;
- (b) Measures to provide oversight of the integrity of information used and to reasonably ensure that the allowances reflected in the licensee's financial statements and its supervisory reports are prepared in accordance with the applicable accounting framework and relevant supervisory guidance;
- (c) Well-defined credit risk assessment and measurement processes that are independent from (while taking appropriate account of) the lending function and include:
  - (i) An effective credit risk rating/ scoring system that is consistently applied, accurately grades differing credit risk characteristics, identifies changes in credit risk on a timely basis, and prompts appropriate action;
  - (ii) An effective process which ensures that all relevant/ reasonable and supportable information, including forward-looking information, is appropriately considered in assessing and measuring expected credit loss ('ECL'). This includes maintaining appropriate reports, details of reviews performed and identification and descriptions of the roles and responsibilities of the personnel involved;



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## CM-1.2 Credit Risk Management Framework (Continued)

- (iii) An assessment policy that ensures ECL measurement occurs not just at the individual lending exposure level, but also when necessary to appropriately measure ECL at the collective portfolio level by grouping exposures based on identified shared credit risk characteristics;
  - (iv) An effective model validation process to ensure that the credit risk assessment and measurement models, including ECL models, are able to generate accurate, consistent and unbiased predictive estimates on an ongoing basis. This includes establishing policies and procedures which set out the accountability and reporting structure of the model validation process, internal standards for assessing and approving changes to the models and reporting of the outcome of the model validation (see also Paragraph CM-1.4.10);
  - (v) Clear formal communication and coordination among the licensee's credit risk staff, financial reporting staff, senior management, the Board and others who are involved in the credit risk assessment and measurement process for an ECL accounting framework, as applicable (e.g. evidenced by written policies and procedures, management reports and committee minutes); and
- (d) An internal audit function that independently evaluates the effectiveness of the licensee's credit risk management framework, and in particular, assessment and measurement systems, models and processes, including the credit risk rating system. Refer to HC-6.5.

**CM-1.2.23** Conventional bank licensees must ensure that the credit risk policy establishes the objectives that guide the licensee's credit-granting activities.

**CM-1.2.24** The credit risk policy must give recognition to the goals of credit quality, earnings quality and sustainability and growth. Conventional bank licensees, regardless of their size, must determine the acceptable risk/reward trade-off for their activities, factoring in the cost of capital.

**CM-1.2.25** The credit risk appetite/limits framework of conventional bank licensees must take into consideration the cyclical aspects of the economy and the resulting shifts in the composition and quality of the overall credit portfolio. The credit granting criteria must be periodically assessed and amended and it must be viable in the long-run and through various economic cycles. The credit risk procedures must be reviewed at least once every three years or more frequently as may be necessary if there are changes in internal or regulatory requirements.



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## CM-1.2 Credit Risk Management Framework (Continued)

**CM-1.2.26** The credit granting criteria must be designed and implemented within the context of internal and external factors, such as the licensee's market position, trade area, staff capabilities and technology.

**CM-1.2.27** Conventional bank licensees must have a clearly defined credit risk appetite statement which is implemented through comprehensive policies and procedures for limiting and controlling credit risk. Conventional bank licensees must also establish credit limits in a meaningful manner for different types of exposures, both on and off-balance sheet.

**CM-1.2.28** Bahraini conventional bank licensees must consider the results of stress testing in the overall limit setting and monitoring process. Such stress testing must take into consideration economic cycles, interest rates and other market movements and liquidity conditions.

### *Country and Transfer Risks*

**CM-1.2.29** Conventional bank licensees must set out their policy on country and transfer risks within their Board approved credit risk policy which must be approved by CBB. Such policy must include:

- the risk appetite/tolerance levels for country and transfer risks;
- country exposure limits;
- basis and frequency for periodic reviews and assessments;
- the criteria for downgrading a country exposure from Stage 1 to Stages 2 or 3, and related provisioning policy; and
- the policy for recategorization of exposure to a higher grade.

CM-1.2.30 Country risk is the exposure to a loss in cross-border lending, caused by events in the country to which the licensee has exposure and includes all forms of lending whether to the government, a bank, a private enterprise or an individual. Country risk is therefore a broader concept than sovereign risk, which is restricted to the risk of lending to the government of a sovereign nation. Transfer risk, on the other hand, represents the risk of loss due to repatriation or remittance restrictions imposed by a foreign government that make it impossible to remit, fully or partially, the proceeds of debt owed to the licensee.

**CM-1.2.31** In the case of exposure to borrowers, conventional bank licensees must examine any associated country and transfer risks keeping in view factors such as domicile of the counterparty, the legal structure of the counterparty, the existence of special purpose vehicles, conduits and/or other related factors that may affect the transferability of proceeds of repayment.



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## CM-1.2 Credit Risk Management Framework (Continued)

**CM-1.2.32** Branches of foreign bank licensees must satisfy the CBB that equivalent arrangements are in place at the parent entity level, otherwise a policy is required in line with Paragraph CM-1.2.28.

CM-1.2.33 Branches of foreign bank licensees are normally subject to country limits that are set at a global level by the head office or by the regional office. The branch should be able to demonstrate that it is subject to limits imposed on it by the head office or regional office as appropriate.



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### CM-1.3 Credit Granting

**CM-1.3.1** The limits framework must ensure that the granting of credit exceeding certain predetermined levels receives prompt management attention. An appropriate limit system must assist the management in initiating discussion about opportunities and risks, in controlling credit risk exposures and monitoring actual risk taking against predetermined credit risk tolerances.

**CM-1.3.2** Conventional bank licensees must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty. Depending on the type of credit exposure and the nature of the credit relationship to date, the factors to be considered and documented in approving credits must include:

- (a) The purpose of the credit and sources of repayment;
- (b) The current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and collateral and its sensitivity to economic and market developments;
- (c) The borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections, under various scenarios;
- (d) For commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
- (e) The proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower;
- (f) The legal structure of the entity to which credit is granted and any associated implications; and
- (g) Where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

**CM-1.3.3** Conventional bank licensees need to understand to whom they are granting credit. As such, prior to entering into any new credit relationship, the licensee must become familiar with the borrower or counterparty and be confident that they are dealing with an individual or organisation of sound repute and creditworthiness. In particular, strict policies must be in place to avoid association with individuals involved in fraudulent activities and other crimes.





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### CM-1.3 Credit Granting (Continued)

**CM-1.3.4** Conventional bank licensees must perform their due diligence at the solo entity level to which there is a credit exposure. In evaluating the repayment capacity of the solo entity, licensees can take into account the support of the group and also the potential for the solo entity to be adversely impacted by problems in the group.

**CM-1.3.5** In considering potential credit, conventional bank licensees must recognise the necessity of establishing provisions for identified and expected losses and hold adequate capital to absorb unexpected losses. The licensee must factor these considerations into credit-granting decisions, as well as into the overall portfolio risk management process.

**CM-1.3.6** Where actual or potential conflicts of interest exist within the conventional bank licensee, internal confidentiality arrangements (e.g. ‘Chinese walls’) must be established and maintained to ensure that there is no hindrance to the licensee in obtaining all relevant information from the borrower.

**CM-1.3.7** In order to maintain a sound credit portfolio, conventional bank licensee must have an established formal transaction evaluation and approval process for the granting of credit. Approvals must be made in accordance with the licensee’s written guidelines and granted by the appropriate level of management. There must be a clear audit trail documenting that the approval process was complied with and identifying the individual(s) and/or committee(s) providing input, as well as making the credit decision. Conventional bank licensees must invest in appropriate credit decision making tools and resources so that they are able to make sound credit decisions consistent with their credit risk strategy and meet competitive time, pricing and structuring pressures.

**CM-1.3.8** Each credit proposal must be subject to careful analysis by an experienced credit analyst with expertise commensurate with the size and complexity of the transaction. An effective evaluation process establishes minimum requirements for the information on which the analysis is to be based.

**CM-1.3.9** Conventional bank licensees must have in place a Board approved policy regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit, and its accuracy and adequacy is critical to the management making appropriate judgments about the acceptability of the credit.



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### CM-1.3 Credit Granting (Continued)

**CM-1.3.10** Credit risk officers must have the experience, knowledge and background to exercise prudent judgment in assessing, approving and managing credit risks. The licensee's credit-granting approval process must establish accountability for decisions taken and designate who has the final or ultimate authority to approve credits or changes in credit terms.

**CM-1.3.11** All extensions of credit must be made on an arm's-length basis. In particular, credits to connected counterparties must be authorised only under exceptional circumstances. Such credits must be monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

**CM-1.3.12** Transactions with connected counterparties must be subject to the approval of the Board of Directors (excluding Board members with conflict of interest).

#### *Credit Reference Requirements*

**CM-1.3.13** Conventional bank licensees which provide credit facilities to natural and legal persons in Bahrain must become members of the Bahrain Credit Reference Bureau ('BCRB'). All enquiries for new or additional credit facilities in Bahrain must be submitted to the BCRB. BCRB members must meet the following requirements and incorporate them into their policies and procedures:

- (a) Establish an electronic monitoring system to detect, monitor and maintain records and a log of all access to BCRB data by the BCRB member's employees;
- (b) Conduct a monthly internal audit on the access logs to identify unauthorised access to BCRB data by any employee without securing customer consent and report to the CBB any observed violation of Article 68 (bis (2)) of CBB Law;
- (c) Require the sign off of a BCRB member's designated employee on their legal obligations concerning the confidentiality of BCRB data and that any violation of Article 68 (bis (2)) of CBB Law would subject them to an enforcement action in accordance with CBB Law; and
- (d) Cover compliance with the above requirements in the performance appraisal of relevant employees.



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### CM-1.3 Credit Granting (Continued)

#### CM-1.3.14

Failure to comply with Article 68 (bis (2)) of the CBB Law and Paragraph CM-1.3.13 may result in an enforcement action taken against the BCRB member, as well as the relevant employee in accordance with CBB Law. Additionally, all BCRB members must abide by the agreed Code of Practice of the BCRB (see Appendix CM-3). Any breaches to the code will be subject to enforcement action by the CBB.

#### *Name-lending*

#### CM-1.3.15

Conventional bank licensees must avoid providing finance to counterparties without collateral or without adequate credit risk analysis performed on the basis of reliable audited financial statements to properly analyse the obligor's ability to repay.

#### CM-1.3.16

Some licensees indulge in 'name-lending' which refers to the practice of lending to businesses and individuals merely on the basis of their 'name' or 'reputation' in the market. In such instances, the licensee, typically, does not receive audited financial statements and other relevant information to conduct a proper credit risk analysis, nor does it receive collateral to support the credit granting decision. The CBB prohibits licensees from engaging in such activities in order to minimise their credit risk and reputational risk.



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#### CM-1.4 Credit Risk Measurement and Monitoring

**CM-1.4.1** Conventional bank licensees must have methodologies that enable them to quantify the risk involved in exposures to individual borrowers or counterparties. Conventional bank licensees must also be able to analyse credit risk at the product and portfolio level, in order to identify any particular sensitivities or concentrations. The measurement of credit risk must take account of the following:

- (a) The specific nature of the credit and its contractual and financial conditions (maturity, reference rate, etc.);
- (b) The exposure profile until maturity in relation to potential market movements;
- (c) The existence of collateral or guarantees; and
- (d) The potential for default based on the internal risk rating.

The analysis of credit risk data must be undertaken at an appropriate frequency, with the results reviewed against relevant limits.

**CM-1.4.2** Conventional bank licensees must use measurement techniques that are appropriate to the complexity and level of the risks involved in their activities, based on robust data and subject to periodic validation.

**CM-1.4.3** Conventional bank licensees must monitor actual exposures against established limits. It is important that licensees have an MIS in place to ensure that exposures approaching risk limits are brought to the attention of senior management. All exposures must be included in a risk limit measurement system. Conventional bank licensee's information system must be able to aggregate credit exposures to individual borrowers and counterparties and report on exceptions to credit risk limits in a meaningful way and on a timely basis.



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#### CM-1.4 Credit Risk Measurement and Monitoring (Continued)

**CM-1.4.4** Conventional bank licensees must take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios and must assess their credit risk exposures under stressful conditions.

**CM-1.4.5** An important element of sound credit risk management involves discussing what could potentially go wrong with individual credits and within the various credit portfolios and factoring this information into the analysis of the adequacy of capital and provisions. The supervisory guidance on accounting for expected credit losses has been provided in Section CM-1.8.

##### *Credit Rating /Scoring*

**CM-1.4.6** Conventional bank licensees must have in place a Board approved policy to develop, review and implement an internal risk rating system. Such a system must be able to assign a credit risk rating or scoring to obligors that accurately reflects the obligors' risk profile and likelihood of loss.

**CM-1.4.7** Conventional bank licensees must assign risk ratings or scoring in a consistent manner to enable the licensee to classify obligors by risk ratings or scoring and have a clearer understanding of the overall risk profile of its portfolio. The licensee's credit risk policy must define the various risk grades of its rating system. Criteria for assigning risk grades and the circumstances under which deviations from the criteria are permitted must be set. The credit risk policy must also define the roles of different parties involved in the rating process.

**CM-1.4.8** The credit risk rating/scoring process must appropriately group credit exposures on the basis of shared credit risk characteristics.

**CM-1.4.9** Conventional bank licensees' credit exposures must be grouped according to shared credit risk characteristics, so that changes in the level of credit risk respond to the impact of changing conditions on a common range of credit risk drivers. This includes considering the effect on the group's credit risk in response to changes in forward-looking information, including macroeconomic factors. The licensee must review the appropriateness of the grouping implemented upon initial recognition based on similar credit risk characteristics, at regular intervals, at least annually, to ensure that the relevant characteristics and their impact on the level of credit risk of the different groupings have not changed over time.



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#### CM-1.4 Credit Risk Measurement and Monitoring (Continued)

##### CM-1.4.10

Conventional bank licensees must validate their risk rating or scoring system and ascertain its applicability to their portfolio prior to implementation. An external independent party, other than the external auditor, with necessary expertise in model validation, must conduct the validation of the risk rating/scoring and ECL models every three years and upon development of the model, and also when there are material changes to the portfolio, rating/scoring model or model parameters (See also Paragraph CM-1.2.22 (c)).

##### CM-1.4.11

Conventional bank licensees that use a judgmental rating or scoring system must ensure that each rating is unique, well-defined and distinct from other ratings in the rating scale. The relevant risk factors and weights employed in the rating/scoring methodology must be appropriate for the risk profile of the obligors in different market segments, such as corporations, small and medium-sized enterprises ('SMEs'), and financial institutions.

##### CM-1.4.12

Risk ratings must be assigned at the inception of lending and updated at least on an annual basis. Additionally, conventional bank licensee must review the ratings or scoring as and when adverse events occur. Risk ratings or risk scores assigned to various obligors must be reviewed by the licensee's personnel that are independent of those involved in loan origination. As part of its portfolio monitoring, the licensee must generate reports on credit exposures by risk rating/scores. Trend and migration analysis between risk ratings /scores must also be conducted to detect changes in the credit quality of the portfolio.

##### CM-1.4.13

The licensee may establish target limits for risk grades to highlight concentration in particular rating bands. The analysis of the portfolio by risk ratings is meaningful only when the licensee's rating or scoring system is able to consistently assign similar ratings or scores to obligors with similar risk profiles.

##### CM-1.4.14

After the credit facility has been granted, its performance must 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 licensee with an opportunity to address problems before losses are sustained. The loan review must ensure that the credit files are complete and that all loan approvals and other necessary documents relating to the obligor are available.



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#### CM-1.4 Credit Risk Measurement and Monitoring (Continued)

**CM-1.4.15** Conventional bank licensees must perform regular credit reviews. The purpose of a credit review is to verify that credits are granted in accordance with the licensee's credit risk policy and to provide an independent judgment of asset quality. Conventional bank licensees must conduct credit reviews with updated information on the obligor's financial and business conditions, as well as the conduct of the account. Exceptions noted must be evaluated for impact on the obligor's creditworthiness.

**CM-1.4.16** Credit reviews must also be conducted on a consolidated group basis to factor in the business connections among connected entities. The performance of the underlying assets in the case of securitisation exposures must also be included in the credit reviews.

**CM-1.4.17** Credit reviews must be performed and documented at least once a year other than for facilities subject to collective assessments. For Stage 2 and 3 accounts (See Paragraph CM-1.8.23), however, more frequent reviews must be conducted. Procedures must also be instituted to ensure that reviews are conducted at the appropriate frequency. A process to approve deferment of credit reviews must also be put in place. For consumer loans, annual credit reviews of individual obligors are only needed if significant and a portfolio analysis does not identify credit risk related issues or problems. However, credit exceptions and deterioration must be monitored and reported.

##### *Credit risk stress testing*

**CM-1.4.18** Stress testing must involve identifying possible events or future changes in economic and other conditions that could have unfavourable effects on the conventional bank licensee's credit exposures and assessing its ability to withstand such changes. Three areas that the licensee could usefully examine are: (i) economic or industry downturns; (ii) market risk events; and (iii) liquidity conditions. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables, to the use of highly sophisticated financial models.



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## CM-1.4 Credit Risk Measurement and Monitoring (Continued)

CM-1.4.19 Stress tests are to be performed by adjusting the parameters and then recalculating credit losses, for example:

- (a) Unfavourable changes (increases/decreases, depending on portfolio composition) in the underlying interest rate by a certain number of basis points; and
- (b) Unfavourable changes (increases/decreases, depending on portfolio composition) in crucial exchange rates by a certain percentage.

CM-1.4.20 In undertaking credit risk stress tests, licensees should consider counterparty-based and credit facility-based risk factors and scenarios that help estimate credit losses after modelling a change in probability of default ('PD') and/or loss given default ('LGD') or exposure at default ('EAD'). Stress testing programmes should consider:

- (a) The inclusion of the licensee's individual credit portfolio composition and compile a list of the credit products in use;
- (b) Identify the decisive risk factors for each individual credit product and develop a basis for prioritising the factors by relevance and to group those risk factors which influence each other strongly under normal conditions or in crisis situations for the development of stress tests;
- (c) Analyse the prevailing social, economic, and political conditions and filter as many potential crisis situations as possible and relevant;
- (d) Use of in-house as well as external expertise, as appropriate, and ensure that the stress tests attain the necessary level acceptance.

CM-1.4.21 The approaches towards modelling stress tests include the following elements considered individually and on a combined basis as appropriate and with varying severity:

- (a) Downgrading all borrowers by one rating class;
- (b) Increasing default probabilities by a certain percentage;
- (c) Increasing LGD by a certain percentage;
- (d) Increasing EAD by a certain percentage for variable credit products (justification: customers are likely to utilize credit lines more heavily in crisis situations, for example);
- (e) Assumption of negative credit spread developments (e.g. parallel shifts in term structures of interest rates) for bonds;
- (f) Modelling of input factors (e.g. balance sheet indicators).

CM-1.4.22 Additionally, the impact of macroeconomic risk factors such as fluctuations in interest rates and/or exchange rates etc. on the following illustrative general conditions may be considered:

- (a) Stress tests for specific industries or regions;
- (b) Downgrading all borrowers in one or more crisis-affected industries; and
- (c) Downgrading all borrowers in one or more crisis-affected regions.





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## CM-1.4 Credit Risk Measurement and Monitoring (Continued)

CM-1.4.23 If the licensee uses risk models (such as credit portfolio models or credit pricing models), it is necessary to perform stress tests which show whether the assumptions underlying the risk models will also be fulfilled in crisis situations. Only then will the models be able to provide the appropriate guidance in crisis situations.

CM-1.4.24 Conventional bank licensees should also examine political risk factors when significant parts of the credit portfolio consist of borrowers from politically unstable countries. Due to the complex interrelationships involved, however, developing plausible stress tests for political risk factors involves far more effort than designing tests for macroeconomic risk factors. It is, therefore, advisable to call in specialists to develop stress tests for political risk factors in order to assess the relevant effects on financial and macroeconomic conditions.

**CM-1.4.25** The output of the stress tests must be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. The output must also be incorporated into the process for assigning and updating policy and limits.

**CM-1.4.26** Conventional bank licensees must attempt to identify the types of situations, such as economic downturns, both in the whole economy or in particular sectors, higher than expected levels of delinquencies and defaults, or the combinations of credit and market events that could produce substantial losses or liquidity problems.



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## CM-1.5 Credit Administration and Collateral Management

**CM-1.5.1** Conventional bank licensees must have in place a system for the ongoing administration of their various credit risk exposures.

**CM-1.5.2** In developing their credit administration areas, conventional bank licensees must ensure:

- (a) The efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral etc.;
- (b) The accuracy and timeliness of information provided in management information systems ('MIS');
- (c) Adequate segregation of duties;
- (d) The adequacy of controls over all 'back office' procedures; and
- (e) Compliance with prescribed policy and procedures, as well as applicable laws and regulations.

**CM-1.5.3** For the various components of credit administration to function appropriately, senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

**CM-1.5.4** The credit files must include all information necessary to ascertain the current financial condition of the borrower or counterparty, as well as sufficient information to track the decisions made and the history of the credit. For example, the credit files must include current financial statements, financial analyses and internal rating documentation, internal memoranda, reference letters and appraisals.

**CM-1.5.5** Conventional bank licensees must develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and single obligors across the licensee's various portfolios. These procedures need to define the criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring, as well as possible corrective action, classification and/or provisioning.

### *Collateral Requirements*

**CM-1.5.6** When the loan decision is primarily based on collateral value, independent and timely appraisals of the collateral by a third party valuation expert must be undertaken, and the licensee must ensure that the collateral value is sufficiently higher than the exposure amount.



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## CM-1.5 Credit Administration and Collateral Management (Continued)

CM-1.5.7 The requirement in Paragraph CM-1.5.6 shall not apply to publicly traded instruments that are provided as collateral for which daily fair value is available from independent sources.

**CM-1.5.8** Conventional bank licensees can utilise the transaction structure, collateral and guarantees to help mitigate risks (both identified and inherent) in individual credits, but transactions must be entered into primarily on the strength of the borrower's repayment capacity. Collateral cannot be a substitute for a comprehensive assessment of the borrower or counterparty, nor can it compensate for insufficient information. It must be recognised that any credit enforcement action (e.g. foreclosure proceedings) can eliminate the profit margin on the transaction. In addition, conventional bank licensees need to be mindful that the value of collateral may well be impaired by the factors that have led to the diminished recoverability of the credit. Conventional bank licensees must have a policy covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral, and a process to ensure that the collateral is, and continues to be, enforceable and realisable. With regard to guarantees, conventional bank licensees must evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor. Licensees must be careful when making assumptions about implied support from third parties, such as the government.

**CM-1.5.9** The value of the collateral must be updated periodically. In adverse market conditions and in the case of collateral that support Stage 2 and 3 credit exposures, the valuations must be conducted at least annually. If the exposure is backed by inventory or goods located in the obligor's premises, additional measures must be in place to physically inspect and verify the existence and valuation of the collateral.

**CM-1.5.10** Since expected credit loss (ECL) provisions are dependent on the recoverable value of collateral held, conventional bank licensees must obtain appropriate valuations of the collateral. The licensee must have a reliable and timely collateral valuation system which must include factors such as the legal enforceability of claims on collateral, ease of realisation of collateral, effects of currency and maturity mismatches, and be based on current market conditions.



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## CM-1.6 Non-Performing Loans Management

**CM-1.6.1** Conventional bank licensees must ensure that their credit policy contains policy on non-performing loans ('NPLs'). Such policy must outline the approach they would take to deal with NPLs in line with the Board approved risk appetite framework including tolerance levels for NPLs for different portfolios. Responsibility for such credit must be assigned to a specialised workout section.

**CM-1.6.2** To formulate and execute a fit-for-purpose policy on NPLs, conventional bank licensees must complete an assessment of the following elements as a minimum:

- The internal capabilities to effectively manage, i.e. maximise recoveries and reduce NPLs over a defined time horizon;
- The external conditions and operating environment; and
- The capital implications of NPLs

**CM-1.6.3** Conventional bank licensees must include, at a minimum, clearly defined quantitative targets for NPLs (where relevant, including targets for foreclosed assets), which must be approved by the senior management. The combination of these targets must lead to a concrete reduction, gross and net (of provisions), of NPL exposures, at least in the medium-term.

CM-1.6.4 While expectations about changes in macroeconomic conditions can play a role in determining target levels (if based on reliable external forecasts), they should not be the sole driver for the established NPL reduction targets. Targets should be established at least along the following dimensions:

- By time horizons, i.e. short-term (indicative 1 year), medium-term (indicative 3 years) and possibly long-term;
- By main portfolios (e.g. retail mortgage, retail consumer, retail small businesses and professionals, SMEs, large corporates and commercial real estate);
- By implementation option chosen to drive the projected reduction, e.g. cash recoveries from hold strategy, collateral repossessions, recoveries from legal proceedings, revenues from sale of NPLs or write-offs.

**CM-1.6.5** When the NPL levels exceed the thresholds under the Board approved Risk Appetite Framework, the conventional bank licensee must develop an NPL operational plan which clearly defines how the licensee will effectively reduce the level of NPLs over a time horizon of at least 1 to 3 years (depending on the type of operational measures required).



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## CM-1.6 Non-Performing Loans Management (Continued)

### CM-1.6.6

Conventional bank licensees must fully understand and examine:

(a) Scale and drivers of the NPL problem:

- (i) The size and evolution of NPL portfolio on an appropriate level of granularity, which requires appropriate portfolio classification as outlined in Section 1.8;
- (ii) The drivers of NPL in-flows and out-flows, by portfolio where relevant; and
- (iii) Other potential correlations and causations.

(b) Outcomes of NPL actions taken in the past:

- (i) Types and nature of actions implemented, including forbearance measures; and
- (ii) The success of the implementation of those activities and related drivers, including the effectiveness of forbearance treatments.

(c) Operational capacities (processes, tools, data quality, IT/automation, staff/expertise, decision-making, internal policies, and any other relevant areas for the implementation of the strategy) for the different process steps involved, including, but not limited to:

- (i) Early warning and detection/recognition of NPLs;
- (ii) Forbearance;
- (iii) Provisioning;
- (iv) Collateral valuations;
- (v) Recovery/legal process/foreclosure;
- (vi) Management of foreclosed assets (if relevant); and
- (vii) Reporting and monitoring of NPLs and effectiveness of NPL workout solutions.

#### *Capital Implications of NPLs*

### CM-1.6.7

Capital levels and their projected trends are important inputs towards determining the scope of NPL reduction actions available to licensees. Conventional bank licensees should dynamically model the capital implications of the different elements of their policy on NPLs, ideally under different economic scenarios. Those implications should also be considered in conjunction with the risk appetite framework as well as the internal capital adequacy assessment process ('ICAAP').

### CM-1.6.8

Where capital buffers are slim and profitability low, conventional bank licensees must include suitable actions in their capital planning, ICAAP and recovery plans which will enable effective management and sustainable clean-up of NPLs.

### CM-1.6.9

Conventional bank licensees should also identify medium and long-term options for NPL reductions.



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## CM-1.6 Non-Performing Loans Management (Continued)

**CM-1.6.10** A strong level of monitoring and oversight by risk management function in respect of the formulation and implementation of the NPL strategy (including the NPL operational plan) must also be ensured.

**CM-1.6.11** Conventional bank licensees must write-off loans which are deemed to be uncollectable in a timely manner.



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## CM-1.7 Credit Risk Reporting

**CM-1.7.1** Conventional bank licensees must have an effective MIS that captures all on and off-balance sheet credit exposures.

**CM-1.7.2** The MIS must enable the senior management to identify any concentrations of risk within the credit portfolio.

**CM-1.7.3** The MIS must comprehensively cover reporting of NPLs, including but not limited to the following:

- (a) NPL related KPIs and performance against the KPIs;
- (b) Forbearance activity levels;
- (c) Early warning indicators;
- (d) Liquidation, foreclosure, provisions for impairment and write offs;
- and
- (e) Risk adjusted returns and capital implications.

**CM-1.7.4** The MIS must be able to aggregate all such credit exposures to a single borrower and also aggregate exposures to groups of accounts under common ownership or control. This data must be aggregated in an accurate and timely manner and monitored as part of the licensee's credit risk management process.

**CM-1.7.5** The MIS must provide the Board and senior management with timely and forward-looking information on credit risk management to support them in identifying emerging concerns on credit risk as well as in managing credit stress events. The MIS must be fit for the purpose of supporting the licensee's day-to-day monitoring of compliance with established policies, procedures and limits.

**CM-1.7.6** Risk management reports must be accurate and precise to ensure that conventional bank licensees' Board and senior management can rely, with confidence, on the aggregated information to make critical decisions about risk.



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## CM-1.7 Credit Risk Reporting (Continued)

### CM-1.7.7

To ensure the accuracy of the reports, conventional bank licensees must maintain, at a minimum, the following:

- (a) Defined requirements and processes to reconcile reports to risk data;
- (b) Automated and manual edit and reasonableness checks, including an inventory of the validation rules that are applied to quantitative information. The inventory must include explanations of the conventions used to describe any mathematical or logical relationships that must be verified through these validations or checks; and
- (c) Integrated procedures for identifying, reporting and explaining data errors or weaknesses in data integrity via exception reports.

### CM-1.7.8

Risk management reports to the Board and senior management must provide a forward-looking assessment of risk and must not just rely on current and past data. The reports must contain forecasts or scenarios for key market variables and the effects on the licensee, so as to inform the Board and senior management of the likely trajectory of the licensee's capital and risk profile in the future.

### CM-1.7.9

Conventional bank licensees must develop an inventory and classification of risk data items which includes a reference to the concepts used to elaborate the reports.

### CM-1.7.10

The credit risk reports must be clear and useful. Reports must reflect an appropriate balance between detailed data, qualitative discussion, explanation and recommended conclusions. Interpretation and explanations of the data, including observed trends, must be clear.

### CM-1.7.11

Conventional bank licensees must confirm periodically with the recipients that the information aggregated and reported is relevant and appropriate, in terms of both quantity and quality, to the governance and decision-making process.

### CM-1.7.12

Conventional bank licensees must assess, periodically, the purpose of each report, adequacy of the scope of the information in the reporting and MIS and set requirements for how quickly the reports need to be produced in both normal and stress/crisis situations. The licensee must routinely test its ability to produce accurate reports within established timeframes, particularly in stress/crisis situations.





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## CM-1.8 Classification and Provisioning

CM-1.8.1 The objective of this section is to set out the requirements and supervisory guidance on the assessment and measurement of expected credit losses and allowances (together referred to as 'ECL'). The supervisory guidance is intended to supplement the guidance under the applicable accounting framework and, where relevant, ensure consistency in application of definitions and other areas of estimates and judgment that are expected to be common across the banking sector. The term 'allowances' includes allowances/provisions on loans, loan commitments, financial guarantees and similar contracts.

**CM-1.8.2** In applying these instructions, conventional bank licensees must make sure that consistent accounting policies are applied at group level including subsidiaries and branches outside Bahrain. If the supervisory and accounting standards applied at the licensee's outside branches or subsidiaries (such as NPL norms) are in conflict with these instructions, the licensee must notify CBB accordingly.

### *Governance*

**CM-1.8.3** Conventional bank licensees' Board of Directors (or equivalent) and senior management are responsible for ensuring that the licensee has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate ECL in accordance with the licensee's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

**CM-1.8.4** Conventional bank licensees must adopt, document and adhere to sound policies, procedures and controls for assessing and measuring ECL on all lending exposures. The measurement of allowances must build upon those robust methodologies and result in the appropriate and timely recognition of ECL in accordance with the applicable accounting framework.



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## CM-1.8 Classification and Provisioning (Continued)

### CM-1.8.5

Conventional bank licensees must have in place a detailed and clear policy statement pertaining to ECL recognition. The policy statement must be approved by the Board of Directors and submitted to the CBB for its review, including at the time of any periodic changes. The policy statement must be comprehensive and must include, but not be limited to, the following components:

- (a) Definition of default (including consideration of cross defaults and restructured/renegeotiated/rescheduled facilities in such assessment);
- (b) Portfolio segmentation, detailing the level at which PD and LGD will be measured;
- (c) For collectively evaluated exposures, a description of the basis for creating groups of portfolios with shared credit risk characteristics;
- (d) Qualitative and quantitative staging criteria, including criteria for qualifying as low credit risk assets and triggers for both forward and backward transition between Stages 1 to 3 (CM-1.8.24);
- (e) Source of internal data sets, minimum period of internal data repository and when external data sets will be used as reliable proxies in assessment of required impairment allowances;
- (f) Identify and document the ECL assessment and measurement methods (such as a loss rate method, PD/LGD modelling methods, prepayment and cure rate models or any another method) to be applied to each exposure, segment or portfolio;
- (g) Methodology for conversion from through-the-cycle ('TTC') to point-in-time ('PIT') PDs and variables considered for making forward-looking adjustments to PIT PDs, including use of macroeconomic factors;
- (h) Determine the extent to which the value of collateral and other credit risk mitigants will be used for LGD calculations (including the use of liquidation haircuts and, where available, forecasting of collateral values);
- (i) Policy for specific cash shortfall assessment for Stage 3 accounts (NPL provisions);
- (j) Document the methods and frequency used to validate models for ECL measurement (e.g. back tests, quantitative and qualitative validation tests). Models, input data and systems used to develop PD, LGD and other components of ECL must be subject to internal and external validation as required under CM-1.4.10; and



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## CM-1.8 Classification and Provisioning (Continued)

- (k) Include a process for evaluating the appropriateness of significant inputs and assumptions in the ECL assessment and measurement method chosen. It is expected that the basis for inputs and assumptions used in the estimation process will generally be consistent from period-to-period. Where the basis of use of inputs and assumptions changes, the rationale must be documented.

### *Definition of Default / Impairment*

#### CM-1.8.6

Default for the purpose of this Module and impairment in the context of credit risk exposure of an obligor as per IFRS 9 is considered to have occurred with regard to a particular obligor when either or both of the following events have taken place:

- (a) The licensee considers that the obligor is unlikely to pay its credit obligations in full (i.e. principal, interest, fees or any other amount), without taking actions such as realising security (if held).
- (b) The obligor is past due for 90 days or more on any credit obligation to the licensee. In case of overdrafts, the customer will be considered as being past due once an advised limit has been breached or the customer has been advised of a limit smaller than the current outstanding amount.

#### CM-1.8.7

The elements to be taken as indications of unlikeliness to pay must include, but not be limited to, the following:

- (a) The licensee puts the interest on the credit obligation on non-accrual status;
- (b) The licensee makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the licensee taking on the exposure;
- (c) The licensee sells the credit obligation at a material credit-related economic loss;
- (d) The licensee consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of repayment instalments;
- (e) The licensee has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the licensee; or
- (f) The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid, or delay, repayment of the credit obligation to the licensee.



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## CM-1.8 Classification and Provisioning (Continued)

CM-1.8.8 For the purpose of CM-1.8.7, distressed restructuring refers to situations when a licensee grants a concession that it would not otherwise consider, irrespective of whether the concession is at the discretion of the licensee or otherwise. Forgiveness means reduction in repayment amount or interest. Postponement could include grace periods or changes in instalments leading to delayed maturity.

### *Identification of Non-performing Exposures*

CM-1.8.9 Non-performing exposures must always be categorised for the whole exposure, including when non-performance relates to only a part of the exposure, for instance, unpaid interest. For off-balance sheet exposures, such as loan commitments or financial guarantees, the whole exposure is the entire uncancellable nominal amount. All non-performing exposures will be classified as Stage 3 for the purpose of ECL calculations.

CM-1.8.10 The following exposures are considered as non-performing:

- (a) All exposures that are 'defaulted' or 'impaired' under Paragraph CM-1.8.6, where applicable;
- (b) All exposures that have experienced a downward adjustment to their valuation due to deterioration of their creditworthiness and classified as Stage 3 according to the applicable accounting framework;
- (c) The purchase or origination of a financial asset at a deep discount that reflects an incurred loss to the lender(s); and
- (d) All other exposures that are not defaulted or impaired but nevertheless:
  - (i) Relate to a counterparty that has other exposures that are past due for 90 days or more; and
  - (ii) Where there is evidence that full repayment based on the contractual terms, original or, when applicable, modified (e.g. repayment of principal and interest) is unlikely without the licensee's realisation of collateral, whether or not the exposure is current and regardless of the number of days the exposure is past due.

CM-1.8.11 The existence of collateral or guarantees must have no direct influence on the categorisation of an exposure as non-performing or its past due status, including the counting of past-due days and the determination of the exposure as non-performing, once the overdue days threshold has been met. However, conventional bank licensees may consider the collateral when assessing a borrower's economic incentive (both positive and negative) to repay under the unlikeliness to repay criteria. Any recourse by the licensee must not be considered in this judgment. When the relevant criteria are met, the exposure must be categorised as non-performing even if the collateral value exceeds the amount of the past-due exposure.



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## CM-1.8 Classification and Provisioning (Continued)

### CM-1.8.12

The classification of an exposure as non-performing must be applied as follows:

- (a) When any one of the material exposures to a non-retail counterparty is categorised as non-performing, all exposures to that counterparty must be categorised as non-performing (i.e. cross-default across obligor);
- (b) In the case of exposures to a retail counterparty, the definition of default may be applied at the level of a particular facility rather than at the level of the obligor. This would be appropriate when the licensee considers the risk of each product and source of repayments having different characteristics for each transaction. In the case of a retail counterparty with more than one exposure from the licensee, it must consider the non-performing or performing status of the other exposures when deciding about the status of a given exposure; and
- (c) In the case of exposures to a group, non-performing status can be applied at the counterparty level. This assumes that the licensee has a separate credit review and rating assigned for each counterparty within the group. At the same time, the licensee must consider the non-performing or performing status of the other group entities when deciding about the status of any of the group entities.

### CM-1.8.13

For the purpose of CM-1.8.12 (a), where a single facility which represents 25% or more of the aggregate exposure to the obligor is non-performing a cross default is deemed to have occurred and, accordingly, all exposures to that obligor will be considered non-performing.

### CM-1.8.14

With reference to Sub-Paragraph CM-1.8.12 (b), however, a default by a borrower on one retail obligation may not require the licensee to treat all other obligations to the licensee as defaulted and non-performing. In these cases, conventional bank licensees must carefully consider the categorisation and staging status of other exposures to the same counterparty (i.e. cross-product default). For example, if a customer has a retail personal loan and an auto loan with the licensee, a default on the personal loan must be considered when assessing the stage classification of the auto loan.



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## CM-1.8 Classification and Provisioning (Continued)

### *Re-categorisation of Non-performing Exposures as Performing*

#### CM-1.8.15

An exposure ceases to be non-performing and can be re-categorised as performing when all the following criteria are met simultaneously:

- (a) The counterparty does not have any exposures that are past due for 90 days or more (see also Paragraph CM-1.8.6);
- (b) Repayments have been made when due over a continuous repayment period of at least:
  - i. Six months for facilities with monthly or quarterly repayment instalments; and
  - ii. Twelve months for facilities with annual or semi-annual instalments.

However, if the payments are not clearly reflective of improvement in the counterparty's financial position, a longer re-payment history or higher number of instalments must be assessed by the licensee before re-categorisation of the exposure to a 'performing' status;

- (c) The counterparty's financial situation has improved so that the full repayment of the exposure is likely, according to the original or, when applicable, modified conditions. This must usually require a credit review process that evaluates the borrower's current capacity to repay, clarity on the source of cash flow available for debt repayments, improvements in the level of indebtedness and compliance with various debt covenants imposed by the licensee. Repayments through liquidation or enforcement of collateral is generally not considered as an improvement in the financial health of the borrower; and
- (d) The exposure is not considered to be in 'default' or 'impaired' according to the applicable accounting framework.

#### CM-1.8.16

Conventional bank licensee must clearly articulate and document policies in respect of the counting of days past due, in particular in respect of the re-ageing of the facilities and the granting of extensions, deferrals, renewals and rewrites to existing accounts. At a minimum, the re-ageing policy must include:

- (a) Approval authorities and reporting requirements;
- (b) Minimum age of a facility before it is eligible for re-ageing;
- (c) Delinquency levels of facilities that are eligible for re-ageing;
- (d) Maximum number of re-ageing allowed per facility; and
- (e) A reassessment of the borrower's capacity to repay.

CM-1.8.17 For the purpose of CM-1.8.16, re-aging occurs when the licensee changes the tenor or due dates of the credit when rescheduling or restructuring a facility.



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## CM-1.8 Classification and Provisioning (Continued)

### CM-1.8.18

Non-performing exposures in the following situations must not be re-categorised as performing without meeting the conditions set forth in CM-1.8.15:

- (a) Partial write-off of an existing non-performing exposure (i.e. when the licensee writes-off part of a non-performing exposure that it deems to be uncollectible);
- (b) Repossession of collateral on a non-performing exposure; or
- (c) Extension or granting of forbearance measures to an exposure that is already identified as non-performing.

The re-categorisation of a non-performing exposure as performing must be made on the same level (i.e. obligor or transaction approach) as when the exposure was originally categorised as non-performing.

### CM-1.8.19

Conventional bank licensees must have the necessary tools to ensure a robust estimate and timely recognition of ECL. Information on historical loss experience or the impact of current conditions may not fully reflect the credit risk in lending exposures. In this context, the licensee must use its experienced credit judgment to thoroughly incorporate the expected impact of all reasonable and supportable forward-looking information, including macroeconomic factors, on its estimate of ECL. The licensee's use of its experienced credit judgment must be documented in the licensee's credit risk methodology and subject to appropriate oversight.

### CM-1.8.20

Applying the concepts of ECL could vary for each licensee depending on its underwriting criteria, loss history, terms of collateral and a number of other variables, both entity-specific and external. Reasonable and supportable information will not present itself, but would rather require management to determine what is relevant and practical, without undue costs or efforts, to actively gather, analyse and process to make required credit risk assessments to support the ECL process. Licensees will need to adopt an appropriate risk assessment methodology which is commensurate with the size, complexity, structure, economic significance and risk profile of their portfolio. This means that, in general, the larger and more complex a portfolio or institution, the more its risk infrastructure should capture relevant and reliable information and trends that would support the development of a sophisticated approach to determine a risk based ECL. Conversely, for smaller and simpler portfolios or institutions, a less sophisticated approach may be adopted to align with the risk management infrastructure and processes within the licensee.



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### *CM-1.8 Classification and Provisioning (Continued)*

CM-1.8.21 Regardless of the size of the licensee or prominence of the portfolio, the approach adopted by the licensee should comply with the specific requirements of this section and applicable accounting standards. It is not necessary that every licensee or every portfolio within the bank would apply the same level of sophistication. However, licensees will need to periodically assess whether their approach continues to be appropriate and relevant in light of changing circumstances with the aim of improving its level of estimation over time.

#### *Measurement Requirements*

CM-1.8.22 The credit impairment assessment under IFRS 9 is based on an expected loss approach, i.e. it is not necessary for a loss event to occur before an ECL is recognised. As a result, all financial assets are generally expected to attract an ECL. For the purpose of Section CM 1.8, any direct credit exposures to the government of Bahrain (or exposures explicitly guaranteed by the government of Bahrain) are exempted from the application of the expected credit loss model.

CM-1.8.23 IFRS 9 requires a three-stage approach to recognise and measure ECL at each reporting date, which is based on changes observed in credit quality of financial assets since origination. The standards prescribe two measures of ECL to be carried by licensees:

- (a) **Twelve-month ECL:** The expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period, but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months; and
- (b) **Life-time ECL:** The expected credit losses that result from all possible default events over the life of the financial instrument.





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## CM-1.8 Classification and Provisioning (Continued)

### CM-1.8.24

The below staging classification must represent migration in credit quality and dictates the level of ECL to be recognised. The following must be followed:

Staging	Description	ECL measure
Stage 1	Performing assets with no significant deterioration in <u>credit risk</u> since origination or with very low <u>credit risk</u> .	12-month ECL
Stage 2	Performing assets that have exhibited significant increase in <u>credit risk</u> since origination.	Life-time ECL
Stage 3	Non-performing assets that are considered credit impaired.	Life-time ECL

CM-1.8.25 The staging classification should normally apply to the entire balance of an outstanding facility because if a problem exists with 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.

### *Regulatory Treatment of Accounting Provisions*

### CM-1.8.26

With reference to CM-1.8.24, the ECL provisions assessed on a collective basis ('CP') relating to Stage 1 and Stage 2 exposures are used for the purposes of regulatory adjustments under Paragraph CA-2.1.8.



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## CM-1.8 Classification and Provisioning (Continued)

### *Restructured Accounts, Forbearance and Modifications*

#### CM-1.8.27

Conventional bank licensees must report restructured accounts to the CBB on a quarterly basis until the satisfactory performance of the account, under revised terms, and the counterparty has resolved its financial difficulty. All NPL accounts restructured must be classified as non-performing and must be subject to the requirements of the Paragraph CM-1.8.15 to CM-1.8.18

#### CM-1.8.28

Forbearance, including synonyms such as ‘restructuring’ occurs when (a) a counterparty is experiencing financial difficulty in meeting its financial commitments; and (b) the licensee grants a concession that it would not otherwise consider, irrespective of whether the concession is at the discretion of the licensee and/or the counterparty. A concession is at the discretion of the counterparty (debtor) when the initial contract allows the counterparty (debtor) to change the terms of the contract in its own favour (embedded forbearance clauses) due to financial difficulty. When such concessions are granted, the facility is ‘restructured’.

#### CM-1.8.29

The following list provides examples of possible indicators of financial difficulty. In particular, financial difficulty can be identified even in the absence of arrears on an exposure:

- (a) A counterparty is currently past due on any of its material exposures.
- (b) A counterparty is not currently past due, but it is probable that the counterparty will be past due on any of its material exposures in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its material exposures.
- (c) A counterparty’s outstanding securities have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange due to noncompliance with the listing requirements or for financial reasons.
- (d) On the basis of actual performance, estimates and projections that encompass the counterparty’s current capabilities, the licensee forecasts that all the counterparty’s committed/available cash flows will be insufficient to service all of its loans or debt securities (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
- (e) A counterparty’s existing exposures are categorised as exposures that have already evidenced difficulty in the counterparty’s ability to repay in accordance with the supervisory categorisation scheme in force or the credit categorisation scheme within the licensee’s internal credit rating system.
- (f) A counterparty is in non-performing status or would be categorised as nonperforming without the concessions.
- (g) The counterparty cannot obtain funds from sources other than the existing banks at an effective interest rate equal to the current market interest rate for similar loans or debt securities for a non-troubled counterparty.

#### CM-1.8.30

Concessions are special contractual terms and conditions that a lender would not extend or consider under normal market conditions.



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## CM-1.8 Classification and Provisioning (Continued)

CM-1.8.31 Licensees should distinguish between restructured loans and rescheduled loans where no concessions have been granted to a performing customer in response to changes in market conditions provided that at the time of rescheduling the loans have been serviced normally, the ability of the borrower to service is not in doubt and where there is reasonable assurance that the borrower will be able to service all future principal and interest payments on the loans in accordance with the revised repayment terms.

**CM-1.8.32** Conventional bank licensees must disclose in their public disclosures their policies and definitions that are integral to the estimation of ECL. Quantitative and qualitative disclosures, taken together, must communicate to users the main assumptions/inputs used to develop ECL estimates.



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## CM-1.9 Provisioning Policies of Branches of Foreign Bank Licensees

### CM-1.9.1

Specific provisions for impaired assets (i.e. Stage 3 accounts) and, where applicable, collective provisions (i.e. Stage 1 and Stage 2) representing ECL on performing exposures of branches of foreign bank licensees must be maintained in the books of the Bahrain branch.

### CM-1.9.2

If a branch of foreign bank licensee which is a wholesale bank licensee is not able to meet the requirement in Paragraph CM-1.9.1, the branch's head office must advise the CBB, on an annual basis and in writing, whether an equivalent or higher amount of specific and collective provisions related to the exposures of its Bahrain branch are being maintained by the head office. In all cases, the branch must maintain and make available all underlying details of such provision calculations at the request of its external auditors and the CBB. The provisions maintained at the head office in relation to exposures of the branch must be disclosed in the financial statements of the branch submitted to the CBB.

### CM-1.9.3

In addition, the CBB may contact the licensee's home supervisor, on a regular or ad hoc basis, in order to obtain information about the adequacy of the provisioning for such assets or may require the licensee to provide additional comfort or assurance, e.g. through external auditors, that such provisions are indeed set aside properly.



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## CM-1.10 Provisions Against Sovereign Debt

CM-1.10.1 CBB has consistently encouraged licensees to maintain adequate provisions against credits for countries with current or potential debt servicing difficulties.

CM-1.10.2 With regard to ‘sovereign debt’, it is particularly important that expected credit loss 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, any 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-1.10.3** **Conventional bank licensees must continue to apply the Sovereign Debt Provisioning Matrix (see Appendix CM-1) as a benchmark for the purpose of comparisons with the level of expected credit loss under IFRS 9. If the expected credit loss determined is lower than the amount identified through the Matrix, and the licensee intends to book the lower amount, then a meeting must be arranged with CBB to discuss the issues before booking these provisions.**

CM-1.10.4 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.



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<b>CHAPTER</b>	<b>CM-2</b>	<b>The Monitoring and Control of Large Exposures</b>

## CM-2.1 Overview

CM-2.1.1 The CBB's directives on large exposures for licensees in Bahrain are issued as part of the CBB's measures to encourage licensees to mitigate risk concentrations and to design the licensees' large exposure framework so that the maximum possible loss the licensee could incur, if a single counterparty or group of connected counterparties were to suddenly fail, would not endanger the licensee's survival as a going concern.

**CM-2.1.2** The contents of this Chapter apply in full to all Bahraini conventional bank licensees on a consolidated basis.

**CM-2.1.3** The application of the large exposures framework at the consolidated level implies that the licensee must consider all exposures to third parties across the relevant regulatory consolidation group and compare the aggregate of those exposures with the group's consolidated total capital.

**CM-2.1.4** Bahraini conventional bank licensees must report large exposures through the PIR forms (see Module CA).



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## **CM-2.2 Exposures Undertaken by Overseas Conventional Bank Licensees**

CM-2.2.1 The CBB may, if circumstances so require and on a case-by-case basis, apply the full or part of the requirements of this Chapter to branches of foreign bank licensees.



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<b>CHAPTER</b>	<b>CM-2 The Monitoring and Control of Large Exposures</b>

### CM-2.3 Measure of Exposure

#### CM-2.3.1

For the purpose of the banking book and the trading book, the measure of exposure, net of specific provisions, reflects the maximum loss that will arise should a counterparty fail, or the loss that may arise due to exposures relating to concentration per product, asset classes, collateral, segments, country, region, currencies, market, etc. In certain cases (particularly derivatives), the measure of an exposure may be larger than that used in published financial statements. Consistent with this, an exposure encompasses the amount at risk arising from the licensee's:

- (a) Claims on a counterparty, including actual and potential claims which would arise from the drawing down in full of undrawn advised facilities (whether revocable/irrevocable, conditional or unconditional) which the licensee has committed itself to provide, and claims which the licensee has committed itself to purchase or guarantee/underwrite. In the case of undrawn facilities (including overdrafts), 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 to be repaid, as shown in the books of the licensee, must be included in the measure of exposure after deduction of any provisions. These claims would include, but are not limited to:
- (i) Loans and other credit facilities (including overdrafts) whether or not drawn;
  - (ii) Exposures arising through lease agreements;
  - (iii) Margin held with exchanges or counterparties;
  - (iv) Claims under derivative contracts such as futures, forwards, options, swaps and similar contracts on interest rates, foreign currencies, equities, securities, commodities or indexes;
  - (v) Claims arising in the course of settlement of securities transactions;
  - (vi) Receivables, such as fees or commissions;
  - (vii) Claims arising in the case of forward sales and purchases of financial instruments in the trading or banking books;
  - (viii) Amounts outstanding under sale and repurchase agreements, forward asset purchase agreements, buyback agreements, stock borrowing/lending or similar transactions;
  - (ix) Bonds, bills or other non-equity financial instruments; and
  - (x) Underwriting exposures for bonds, bills, or other non-equity financial instruments.





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### CM-2.3 Measure of Exposure (Continued)

- (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 licensee has committed itself to provide. In the case of an undrawn overdraft, letter of credit ('L/C') or similar facility, the advised limit must be included in the measure of exposure. Such liabilities may include:
- (i) Direct credit substitutes (including guarantees, standby letters of credit, bills accepted but not held by the reporting bank, and endorsements creating payable obligations);
  - (ii) Claims sold with recourse (i.e. where the credit risk remains with the reporting bank);
  - (iii) Transaction-related contingents not having the character of direct credit substitutes (e.g. performance bonds, bid bonds, transaction-related L/Cs etc.);
  - (iv) Undrawn documentary letters of credit issued or confirmed;
  - (v) Credit derivatives sold (where the licensee is providing credit protection); and
  - (vi) Asset value guarantees (where the licensee provides protection on exit price or realisable value of a non-financial asset).
- (c) Any other assets or transactions whose value depends wholly or mainly on a counterparty performing its obligations, or whose value depends upon that counterparty's financial soundness, but which do not represent a claim on the counterparty. Such assets or transactions include:
- (i) Equities and other capital instruments;
  - (ii) Equity warrants, options, or equity derivatives where the reporting bank is obtaining credit protection; and
  - (iii) Underwriting or purchase commitments for equities.
- (d) Investments transactions in trading book (e.g. index positions, securitisations, investments in hedge funds or investment funds) must be calculated by applying the same rules as for similar instruments in the banking book (see Paragraph CM-2.3.27 to CM-2.3.41). The amount invested in a particular structure may be assigned to the structure itself, defined as a distinct counterparty to the counterparties corresponding to the underlying assets, or to the unknown client.



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### CM-2.3 Measure of Exposure (Continued)

**CM-2.3.2** Where the licensee has a legally enforceable netting arrangement in place for loans and deposits, it may calculate the exposure values for large exposures in accordance with Section CA-4.4.

#### *Eligible Credit Risk Mitigation ('CRM') Techniques*

**CM-2.3.3** Bahraini conventional bank licensee must recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate the risk-based capital requirements under Chapter CA-4. Eligible credit risk mitigation techniques for large exposures are those that meet the minimum requirements and eligibility criteria for the recognition of unfunded credit protection and financial collateral that qualify under Chapter CA-4. Other forms of collaterals, e.g. receivables, commercial and residential real estate are not eligible to reduce exposure values for large exposure purposes unless the title deeds, in the case of real estate, are held in the name of the licensee and it is able to demonstrate that it has the ability to realise the value of the collateral.

**CM-2.3.4** In accordance with Paragraph CA-4.6.3, hedges with maturity mismatches are recognised only when their original maturities are equal to or greater than 1 year and the residual maturity of a hedge is not less than 3 months.

**CM-2.3.5** If there is a maturity mismatch in respect of credit risk mitigants (collateral, on balance sheet netting, guarantees and credit derivatives) recognised under Paragraph CA-4.6.3, the adjustment of the credit protection for the purpose of calculating large exposures must be calculated according to CA-4.6.4.

**CM-2.3.6** Bahraini conventional bank licensee must reduce the value of the exposure to the original counterparty by the amount of eligible CRM technique recognised under Chapter CA-4. The recognised amount is:

- The value of the protected portion in the case of unfunded credit protection;
- The value of the portion of the claim collateralised by the market value of the recognised financial collateral when the licensee uses the simple approach under Section CA-4.2; and
- The value of the collateral adjusted after applying the required haircuts, in the case of financial collateral when the licensee applies the comprehensive approach (see Section CA-4.3).



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### CM-2.3 Measure of Exposure (Continued)

**CM-2.3.7** The exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions, must be the exposure at default according to the standardised approach for the purpose of computing capital adequacy (See Module CA).

**CM-2.3.8** Off-balance sheet items must be converted into credit exposure equivalents through the use of credit conversion factors ('CCFs') by applying the CCFs set-out in Section CA-3.3, with a floor of 10 percent.

**CM-2.3.9** Instruments such as swaps, futures, forwards and credit derivatives must be converted into positions following Section CA-3.3. These instruments are decomposed into their individual legs.

**CM-2.3.10** For credit derivatives that represent sold protection, the exposure to the referenced name must be the amount due in cases where the referenced name triggers the instrument, minus the absolute value of the credit protection. For credit-linked notes, the protection seller needs to consider positions both in the bond of the note issuer and in the underlying referenced by the note.

**CM-2.3.11** The measures of exposure values of options for this Chapter differ from the exposure value used for purposes of Chapter CA-4. The exposure value must be based on the change(s) in option prices that would result from a default of the respective underlying instrument. The exposure value for a simple long call option is its market value and for a short put option is the strike price of the option minus its market value. In cases involving short-call or long-put options, a default of the underlying would lead to a profit (i.e. a negative exposure) instead of a loss, resulting in an exposure of the option's market value in the former case and equal the strike price of the option minus its market value in the latter case. The resulting positions will, in all cases, be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.

**CM-2.3.12** In case of syndicated facilities initially underwritten by the licensee, the nominal amount would include only the licensee's share of the syndication and any amounts for which binding commitments from other financial institutions are not available or have not been sold down. Where a binding commitment is available, that amount would be excluded in calculation of the large exposures. See Section CM-2.6 for exemptions.



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### CM-2.3 Measure of Exposure (Continued)

#### *Offsetting Long and Short Positions in the Trading Book*

**CM-2.3.13** Bahraini conventional bank licensee'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). The licensee'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 these securities.

**CM-2.3.14** Positions in the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical) may only be offset for the purpose of calculating large exposure.

**CM-2.3.15** Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.

**CM-2.3.16** For positions hedged by credit derivatives, the hedge may be recognised provided the underlying of the hedge and the position hedged fulfil the provision of Paragraph CM-2.3.15.

**CM-2.3.17** When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for the purpose of this Chapter.

CM-2.3.18 In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, 'equity', 'subordinated debt' and 'senior debt').

**CM-2.3.19** When the credit protection takes the form of a Credit Default Swap ('CDS') and either the CDS provider or the referenced entity is not a financial entity, the amount to be assigned to the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but, instead, the counterparty credit risk exposure calculated in accordance with Module CA .



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### CM-2.3 Measure of Exposure (Continued)

**CM-2.3.20** Bahraini conventional bank licensee must add any exposure to any single counterparty arising in the trading book to any other exposures to that counterparty that lie in the banking book to calculate its total exposure to that counterparty.

**CM-2.3.21** Netting across the banking and the trading books is not permitted.

#### *Covered Bonds*

**CM-2.3.22** Covered bonds are bonds issued by a bank or mortgage institutions and are subject by law to special public supervision designed to protect bond-holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

**CM-2.3.23** A covered bond satisfying the conditions set out in Paragraph CM-2.3.24, may be assigned an exposure value of no less than 20 percent of the nominal value of the licensee's covered bond holding. Other covered bonds must be assigned an exposure equal to 100 percent of the nominal value of the licensee's covered bond holding. The counterparty to which the exposure value is assigned is the issuing bank.

**CM-2.3.24** To be eligible to be assigned an exposure value of less than 100 percent, a covered bond must satisfy all the following conditions:

- (a) It must meet the general definition set out in CM-2.3.22.
- (b) The pool of underlying assets must exclusively consist of one or more of the following:
  - (i) Claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;
  - (ii) Claims secured by mortgages on residential real estate that would qualify for a 35 percent or lower risk-weight under Section CA-3.2 and have a loan-to-value ratio of 80 percent or lower;
  - (iii) Claims secured by commercial real estate that would qualify for the 100 percent or lower risk-weight under Section CA-3.2 and with a loan-to-value ratio of 60 percent or lower; and/or
  - (iv) Claims on, or guaranteed by banks that qualify for a 30 percent or lower risk weight. However, such assets cannot exceed 15 percent of covered bond issuances; and



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### CM-2.3 Measure of Exposure (Continued)

- (c) The nominal value of the pool of assets assigned to the covered bond instrument(s) by its issuer must exceed its nominal outstanding value by at least 10 percent. The value of the pool of assets for this purpose does not need to be that outlined by the legislative framework. However, if the legislative framework does not stipulate a requirement of at least 10 percent, the issuing bank needs to publicly disclose on a regular basis that their cover pool meets the 10 percent requirement in practice. In addition to the primary assets listed under this Sub-paragraph, the additional collateral may include substitution assets (cash or short-term liquid and secure assets held in substitution of the primary assets to top up the cover pool for management purposes) and derivatives entered into for the purposes of hedging the risks arising in the covered bond program.

#### CM-2.3.25

In order to calculate the required maximum loan-to-value for residential real estate and commercial real estate referred to in Paragraph CM-2.3.24, the following requirements must be met:

- (a) **Legal Enforceability:** Any claim on a collateral taken must be legally enforceable in all relevant jurisdictions, and any claim on collateral must be properly filed on a timely basis. Collateral interests must reflect a perfected lien (i.e. all legal requirements for establishing the claim have been fulfilled). In addition to this, the collateral agreement and the legal process underpinning it must be such that they allow the licensee to realise the value of the collateral within a reasonable timeframe; and
- (b) **Frequent Revaluation:** The licensee must monitor the value of the collateral on a frequent basis and, at a minimum, once a year. More frequent monitoring is suggested where the market is subject to significant changes in conditions. Statistical methods of evaluation (e.g. reference to house price indices, sampling) may be used to update estimates or to identify collateral that may have declined in value and that may need reappraisal. A qualified professional must evaluate the property when information indicates that the value of the collateral may have declined materially relative to general market prices, or when a credit event, such as a default, occurs.

#### CM-2.3.26

The conditions set out in Paragraph CM-2.3.24 must be satisfied at the inception of the covered bond and throughout its remaining maturity.



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### CM-2.3 Measure of Exposure (Continued)

#### *Collective Investment Undertakings, Securitisation Vehicles and Other Structures*

CM-2.3.27

Bahraini conventional bank licensees must consider exposures even when a structure lies between the licensee and the exposures, that is, even when the licensee invests in structures through an entity which itself has exposures to assets ('underlying assets'). Bahraini conventional bank licensees must assign the exposure amount, i.e. the amount invested in a particular structure, to specific counterparties following the approach described in Paragraphs CM-2.3.28 to CM-2.3.35. The structures include funds, securitisations and other structures with underlying assets.

CM-2.3.28

Bahraini conventional bank licensee may assign the exposure amount to the structure itself, defined as a distinct counterparty, if it can demonstrate that the licensee's exposure amount to each underlying asset of the structure is smaller than 1 percent of total consolidated capital, considering only those exposures to underlying assets that result from the investment in the structure itself, and using the exposure value calculated according to Paragraphs CM-2.3.34 and CM-2.3.35. In this case, the licensee is not required to look through the structure to identify the underlying assets.

CM-2.3.29

Bahraini conventional bank licensees must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 1 percent of total consolidated capital. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The licensee's exposure amount to the underlying assets that are below 1 percent of the licensee's total consolidated capital may be assigned to the structure itself (i.e. partial Look-Through-Approach ('LTA') is permitted).

CM-2.3.30

If a Bahraini conventional bank licensee is unable to identify the underlying assets of a structure where the total amount of its exposure does not exceed 1 percent of its Total consolidated capital, the licensee must:

- (a) Assign the total exposure amount of its investment to the structure;  
or
- (b) Assign this total exposure amount to the unknown client.



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### CM-2.3 Measure of Exposure (Continued)

**CM-2.3.31** Bahraini conventional bank licensees must aggregate all ‘unknown exposures’ as if they are related to a single counterparty (the unknown client), to which the large exposure limit would apply.

**CM-2.3.32** When a LTA is not required, according to Paragraph CM-2.3.28, a Bahraini conventional bank licensee must, nevertheless, be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – e.g. that the licensee has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.

**CM-2.3.33** If the LTA need not be applied, Bahraini conventional bank licensee’s exposure to the structure must be the nominal amount it invests in the structure.

**CM-2.3.34** When the LTA is required, the exposure value assigned to a counterparty is equal to the pro rata share that the licensee holds in the structure multiplied by the value of the underlying asset in the structure. Thus, the licensee holding a 1 percent share of a structure that invests in 20 assets each with a value of 5, must assign an exposure of 0.05 to each of the counterparties. An exposure to a counterparty must be added to any other direct or indirect exposures the licensee has to that counterparty.

**CM-2.3.35** When the LTA is required, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, the licensee must:

- (a) Consider the lower of the value of the tranche in which the licensee invests and the nominal value of each underlying asset included in the underlying portfolio of assets; and
- (b) Apply the pro rata share of the licensee’s investment in the tranche to the value determined in the first step above.





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### CM-2.3 Measure of Exposure (Continued)

#### *Identification of Additional Risks*

##### CM-2.3.36

Bahraini conventional bank licensees must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. This third party could be a risk factor for more than one structure that the licensee invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.

##### CM-2.3.37

Bahraini conventional bank licensees should connect their investments in those structures with a common risk factor, to form a group of connected counterparties. In such cases, the manager would be regarded as a distinct counterparty so that the sum of the licensee's investments in all of the funds managed by this manager would be subject to the large exposure limit, with the exposure value being the total value of the different investments. In other cases, the identity of the manager may not comprise of an additional risk factor – for example, if the legal framework governing the regulation of particular funds requires separation between the legal entity that manages the fund, and the legal entity that has custody of the fund's assets.

##### CM-2.3.38

In the case of structured finance products, the liquidity provider or sponsor of short-term programmes (asset-backed commercial paper – 'ABCP', or conduits and structured investment vehicles – 'SIVs') may warrant consideration as an additional risk factor (with the exposure value being the amount invested). Similarly, in synthetic deals, the protection providers (sellers of protection by means of CDS/guarantees) may be an additional source of risk and a common factor for interconnecting different structures (in this case, the exposure value would correspond to the percentage value of the underlying portfolio).

##### CM-2.3.39

Bahraini conventional bank licensees may add their investments in a set of structures associated with a third party that constitutes a common risk factor to other exposures (such as a loan) it has to that third party. Whether the exposures to such structures must be added to any other exposures to the third party, would again depend on a case-by-case consideration of the specific features of the structure and on the role of the third party. In the example of the fund manager, adding together the exposures may not be necessary because potentially fraudulent behaviour may not necessarily affect the repayment of a loan.



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## CM-2.3 Measure of Exposure (Continued)

### *Identification of Additional Risks*

CM-2.3.40 It is conceivable that the licensee may consider multiple third parties to be potential drivers of additional risk. In this case, the licensee should assign the exposure resulting from the investment in the relevant structures to each of the third parties.

CM-2.3.41 The requirement set out in Paragraph CM-2.3.36 to recognise a structural risk inherent in the structure instead of the risk stemming from the underlying exposures is independent of whatever the general assessment of additional risks concludes.

### *Exposures to Central Counterparties*

**CM-2.3.42** Exposures to qualified central counterparties ('QCCPs') related to clearing activities are exempted from the requirements of this Chapter.

**CM-2.3.43** In the case of non-QCCPs, Bahraini conventional bank licensees must measure their exposure as a sum of both the clearing exposures described in Paragraph CM-2.3.45 and the non-clearing exposures described in Paragraph CM-2.3.48 and must respect the general large exposure limit of 15 percent of Total consolidated capital.

**CM-2.3.44** The concept of closely related counterparties referred to in CM-2.5.4 does not apply in the context of exposures to centralised counterparties ('CCPs') that are specifically related to clearing activities.



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### CM-2.3 Measure of Exposure (Continued)

#### *Identification of Additional Risks*

CM-2.3.45

Bahraini conventional bank licensees must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below, together with the exposure value to be used:

Trade Exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in this Chapter for the respective type of exposures.
Segregated Initial Margin	The exposure value is 0.
Non-segregated Initial Margin	The exposure value is the nominal amount of initial margin posted.
Pre-funded Default Fund Contributions	Nominal amount of the funded contribution.
Unfunded Default Fund Contributions	The exposure value is 0.
Equity Stakes	The exposure value is the nominal amount.

CM-2.3.46

Regarding exposures subject to clearing services (the licensee acting as a clearing member or being a client of a clearing member), the licensee must determine the counterparty to which exposures must be assigned by applying the provisions of Module CA.

CM-2.3.47

Bahraini conventional bank licensees must apply a risk weight of 2 percent to their trade exposure to the CCP in respect of OTC derivatives, exchange-traded derivative transactions, securities financing transactions (SFTs) and long-settlement transactions, where the licensee acts as a clearing member of a CCP for its own purposes. Where the clearing member offers clearing services to clients, the 2 percent risk weight also applies to the clearing member's trade exposure to the CCP that arises when the clearing member is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults.



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### CM-2.3 Measure of Exposure (Continued)

#### CM-2.3.48

Other types of exposures that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees, etc. must be measured according to the rules set out in this Chapter as for any other type of counterparty. These exposures will be added together and be subjected to the large exposure limit.



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#### CM-2.4 Identity of Counterparty

**CM-2.4.1** For the purposes of measuring exposures, the counterparty will generally be the person from whom the concerned funds are receivable (in the case of fees and commissions etc.), the borrower (customer) in the case of credit facilities; 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-2.4.2** Where a third party has provided an eligible guarantee, and subject to the guaranteed licensee's policy statement not stating otherwise, the guaranteed licensee must recognise an exposure to the third-party guarantor, rather than the person guaranteed (see Chapter CA-4 for full conditions relating to the recognition of guarantees for regulatory purposes).



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## CM-2.5 Limits for Large Exposures

### *Definitions and Aggregate Limit on Large Exposures*

**CM-2.5.1** A 'large exposure' is any exposure to a counterparty or a group of closely related counterparties which is greater than, or equal to, 10 percent of the reporting Bahraini conventional bank licensee's Total Consolidated capital but excluding intragroup exposures.

**CM-2.5.2** CBB requires that any large exposure, as defined in Paragraph CM-2.5.1, must have a prior approval by the Bahraini conventional bank licensee's Board of Directors unless the exposure was incurred within the specific borrower limits for which the licensee has prior Board approval.

### *Single Exposure Limit to a counterparty – 15 Percent*

**CM-2.5.3** A Bahraini conventional bank licensee may not incur an exposure to an individual counterparty or a group of closely related counterparties (not connected to the reporting licensee) which is 15 percent or more of the reporting licensee's Total consolidated capital without the prior written approval of the CBB. Where this limit has been exceeded, the excess amount must be risk-weighted at 800 percent.

### *Closely related counterparties – Criteria*

**CM-2.5.4** In order for the licensee to establish the existence of a group of closely related counterparties, it must assess the relationship amongst counterparties by referring to one or more of the following criteria:

(a) Control relationship: One of the counterparties, directly or indirectly, has control over the other(s) based on the following:

- (i) Where one entity owns 50% or more of the voting rights of another entity.
- (ii) Where one entity is deemed to have control by virtue of voting agreements (e.g. control of a majority of voting rights pursuant to an agreement with other shareholders).
- (iii) Where one entity exercises significant influence on the appointment or dismissal of an entity's board and/or senior management, such as the right to appoint or remove a majority of such persons, or the fact that a majority of such persons have been appointed solely as a result of the exercise of an individual entity's voting rights.



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## CM-2.5 Limits for Large Exposures (Continued)

(iv) Where one entity has significant influence on the board or senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g. through consent rights over key decisions).

; or

(b) Economic interdependence: If one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.

CM-2.5.5 Bahraini conventional bank licensees are also expected to refer to criteria specified in IFRS for further qualitative guidance when determining control.

**CM-2.5.6** Bahraini conventional bank licensees must assess the control relationship using the following criteria:

- (a) Voting agreements (e.g. control of a majority of voting rights pursuant to an agreement with other shareholders);
- (b) Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;
- (c) Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g. through consent rights over key decisions).

CM-2.5.7 The CBB will exercise its discretion in applying the definition of closely related counterparties on a case-by-case basis if it finds, during its onsite or offsite supervisory review, any linkage of such counterparties.



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## CM-2.5 Limits for Large Exposures (Continued)

### CM-2.5.8

In establishing closely related counterparty relationships based on economic interdependence (CM-2.5.4 (b)), licensees must consider, at a minimum, the following qualitative criteria:

- (a) Where 50 percent or more of one counterparty's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
- (b) Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
- (c) Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
- (d) When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
- (e) Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
- (f) Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); and
- (g) When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found. In this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.





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## CM-2.5 Limits for Large Exposures (Continued)

### *Limit on Exposures to connected counterparties – 25 Percent Aggregate*

**CM-2.5.9** Exposures to connected counterparties of Bahraini conventional bank licensees may be justified only when undertaken for the clear commercial advantage of the licensee, when negotiated and agreed on an arm's-length basis, and when included in the Large Exposures Policy statement agreed with the CBB.

**CM-2.5.10** A Bahraini conventional bank licensee may not exceed the individual or aggregate limits for exposures to connected counterparties shown in Paragraph CM-2.5.15, without the prior written approval of the CBB.

**CM-2.5.11** The licensee may not undertake exposures to its own external auditor. In this context, 'external auditor' refers to the firm/partnership, the partners, the directors and the managers of the audit firm.

**CM-2.5.12** For the purpose of this Module, 'connected counterparties' include legal and natural persons connected with the Bahraini conventional bank licensee, including, in particular; controllers of the licensee (and Board members, senior management and key staff of the controller, the controller's appointed Board representatives, subsidiaries and associated companies of controllers including their Board members, senior management and key staff), approved persons of the licensee, as defined by Module LR-1A, and their close family members (as defined by IFRS – IAS 24); associated companies not mentioned hereinabove, unconsolidated subsidiaries and members of the Shari'a Supervisory Board ('SSB'), if any.

CM-2.5.13 Equity participations in, and credit exposures to, consolidated banking and financial subsidiaries (see CA-2.3.1(c)) need not be included in exposures to connected counterparties for the sake of the table in CM-2.5.15. Equity participations in, and credit or financing exposures to, unconsolidated subsidiaries are included in the definition of exposure in order to understand the degree of support the parent is supplying to its unconsolidated subsidiaries on a day-to-day basis.

CM-2.5.14 The CBB will exercise its discretion in applying the definition of connected counterparties of the licensee on a case-by-case basis, if it finds during its onsite or offsite supervisory review any linkage of such counterparties.



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## CM-2.5 Limits for Large Exposures (Continued)

### CM-2.5.15

Exposures (both on and off-balance sheet) to all connected counterparties of Bahraini conventional bank licensees listed below, when taken together, may not exceed 25 percent of the Total consolidated capital. Where any of these limits have been exceeded, the excess amount must be risk-weighted at 800 percent.

<u>Connected Counterparties</u>	<b>Individual Limit</b>	<b>Aggregate Limit</b>
<u>Controllers</u> and their close family members as defined in IFRS, and Board members, senior management and key staff of the <u>controller</u> , the <u>controller's</u> appointed Board representatives, <u>subsidiaries</u> and associated companies of <u>controllers</u> including their Board members, senior management and key staff	0%	0%
<u>Approved persons</u> (and their close family members as defined in IFRS) and members of the SSB	10%	25%
Associated companies not mentioned hereinabove, other connected <u>counterparties</u> not mentioned above, and unconsolidated subsidiaries	15%	
<b>Total (including senior management and others)</b>		<b>25%</b>



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## CM-2.5 Limits for Large Exposures (Continued)

### *Deductions from Total Capital*

CM-2.5.16 The CBB will closely examine all exposures to ‘connected counterparties’ and will deduct them from the licensee’s consolidated total capital if they are, in the CBB’s opinion, of the nature of a capital investment, or provision of long-term working capital, or are made on particularly concessionary terms.

**CM-2.5.17** **Reciprocal cross-holdings of capital between the licensee and its controllers (see GR-5) which artificially inflate the capital of licensee concerned are not permitted. Any cross-holdings that occur, due to acquisitions or takeovers, must be deducted from the concerned licensee’s total capital (see also CA-2).**

CM-2.5.18 Any other form of lending to connected counterparties outside the scope of the above will be dealt with by the CBB on a case-by-case basis.

**CM-2.5.19** **Bahraini conventional bank licensees must perform valuations of collaterals covering large exposures to ensure that collaterals are, and continue to be, enforceable and realisable at least on an annual basis when market conditions are adverse.**



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## CM-2.6 Exempt Exposures

### *Exempt Exposures to Parties not Connected to the Bank*

**CM-2.6.1** Certain types of exposure are exempt from the 15 percent exposure limit set out in CM-2.5.3, but commitment to such exposures must be reported to the CBB on a quarterly basis using the Form PIR provided in Appendix BR-5.

**CM-2.6.2** These exemptions fall into the following categories and are subject, in each case, to the policy statement as agreed with the CBB:

- (a) Short term interbank exposures, with original maturities of 3 months or less to parties not connected to the reporting licensee;
- (b) Exposures to GCC governments and their public sector entities that are not connected to the reporting licensee and do not operate on a commercial basis, as set out in the guidelines to the PIR (see Module CA).
- (c) Exposures secured by cash or GCC government securities or guarantees;
- (d) Exposures to central governments who are members of the Organisation for Economic Cooperation and Development ('OECD') or exposures secured by OECD central government securities/guarantees;
- (e) Pre-notified exposures which are covered by a guarantee from the licensee's parent (see Paragraphs CM-2.6.9 to CM-2.6.12); and
- (f) Sukuk or other securities issued or exposure to / exposure guaranteed by the Islamic Development Bank or any of its subsidiaries and other multilateral development banks, such as IMF, World Bank, Arab Monetary Fund, Asian Development Bank, African Development Bank, European Bank of Reconstruction and Development.

CM-2.6.3 Where two or more entities that are outside the scope of sovereign exemption are controlled by or are economically dependent on an entity that falls within the scope of the sovereign exemption referred to in paragraph CM-2.6.2, and are closely related, those entities need not be deemed to constitute a group of closely related counterparties pursuant to paragraph CM-2.5.4. Additionally, consistent with Module CA, where other supervisors also treat claims on named PSEs as claims on their sovereigns, claims to those PSEs are treated as claims on the respective sovereigns.

**CM-2.6.4** If a Bahraini conventional bank licensee has an exposure to any entity noted in Paragraph CM-2.6.2 which is hedged by a credit derivative, the licensee will have to recognise an exposure to the counterparty providing the credit protection, as prescribed in Paragraphs CM-2.4.2 and CM-2.3.16, notwithstanding the fact that the original exposure is exempted.



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## CM-2.6 Exempt Exposures (Continued)

### *Exempt Exposures to Connected Counterparties*

**CM-2.6.5** Exposures to subsidiaries which are always fully consolidated on a line-by-line basis for all supervisory purposes are exempt from the limits in this Module on a consolidated basis. However, licensees must observe the CBB's solo capital adequacy requirements in Module CA.

**CM-2.6.6** Exposures to unconsolidated subsidiaries (normally non-financial and outside the scope of regulatory consolidation) are not exempt from the limits in this Module and are included under the limits for exposures to associates, related parties and unconsolidated subsidiaries (See Paragraph CM-2.5.14).

**CM-2.6.7** Bahraini conventional bank licensees may apply to the CBB 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 CBB's policy regarding the taking on of a treasury role includes exposures arising from a central risk management function. Such exposures must be approved by the CBB before they may be exempted.

CM-2.6.8 In the above scenario (Paragraph CM-2.6.7), for example, exposures of more than 15% of Total Consolidated Capital 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-2.6.9** Where exposures undertaken by a Bahrain subsidiary of an overseas bank are guaranteed by its parent bank, the Bahrain subsidiary bank may be deemed to have an exposure to its parent bank.

**CM-2.6.10** Under the terms of this Module (see Sub-Paragraph CM-2.6.2(f)), such indirect exposures to a parent bank may be exempted from the limits on large exposures if the CBB is satisfied that:

- (a) Such exposures have been pre-notified to the CBB for the CBB's approval and are entered into within the terms of a policy agreed by the parent bank;
- (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; and
- (c) In the case of licensees which are the Bahrain subsidiaries of overseas licensees, the supervisory authority of the parent bank has approved the exposures that can be undertaken by the Bahrain subsidiary.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2</b>	<b>The Monitoring and Control of Large Exposures</b>

## CM-2.6 Exempt Exposures (Continued)

### CM-2.6.11

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

CM-2.6.12 The CBB 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.



MODULE	CM:	Credit Risk Management
CHAPTER	CM-2	The Monitoring and Control of Large Exposures

## CM-2.7 Reporting of Exposures

**CM-2.7.1** Conventional bank licensees are required to report their 25 largest exposures to banks as well as their 25 largest exposures to non-banks to the CBB on a quarterly basis using the Form PIR provided in Appendix BR-5.

**CM-2.7.2** Bahraini conventional bank licensees must report the financial details of each large exposure, as defined under Paragraph CM-2.5.1 in Appendix BR-19, as required under Paragraph BR-3.1.10.

**CM-2.7.3** Bahraini conventional bank licensees must report all their exposures to connected counterparties on a monthly basis using the form provided in Appendix BR-11, as required under Paragraph BR-4.3.4.

**CM-2.7.4** Bahraini conventional bank licensees 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-2.7.5 For some licensees, the CBB may determine it prudent to set lower large exposure limits than the ones given in this Module.

**CM-2.7.6** Should any licensee incur or plans to incur an exposure to an individual counterparty (other than an exempt exposure) which results in or may result in it exceeding any of the limits set out above, this must be reported immediately to the CBB for its consideration. Where the exposure or counterparty is not exempt, action must be taken to immediately bring the exposure back within applicable limits as soon as possible.



MODULE	CM: Credit Risk Management
CHAPTER	CM-2 The Monitoring and Control of Large Exposures

## CM-2.8 Policy Statements

**CM-2.8.1** The CBB requires each Bahraini conventional bank licensee to set out its policy and internal limits on large exposures, including limits for differing types of exposures, to individual customers, banks, corporates, countries, regions, products, asset classes, collateral, currencies, markets, commodities, connected counterparties and economic sectors, in a policy statement which must be formally approved by the Board of Directors and then submitted to the CBB for approval. Furthermore, licensees must not implement significant changes to this policy without the prior approval of the Board and the CBB.

**CM-2.8.2** The necessary control systems to give effect to the licensee's policy on large exposures must be clearly specified and monitored by its Board.

**CM-2.8.3** Bahraini conventional bank licensees are required to implement appropriate internal systems and controls to monitor the size of their total consolidated capital on a daily basis to ensure that the limits detailed in this Module are not exceeded.





<b>MODULE</b>	<b>CM: Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2 The Monitoring and Control of Large Exposures</b>

## CM-2.9 Concentrations in Geographic, Economic and Market Sectors

CM-2.9.1 The extent to which a licensee may be prudently exposed to a particular geographic, economic and market sectors will vary considerably, depending upon the characteristics and strategy of the licensee, and the sector concerned.

CM-2.9.2 Concentrations should also be recognised in not just geographic and economic sectors but also in markets (e.g. individual stock exchanges). The CBB will not apply common maximum percentages to licensees' sectoral or market exposures but, instead, will continue to monitor such exposures on an individual and general basis.

**CM-2.9.3** Bahraini conventional bank licensees must specify in their policy statements how they define geographic, economic and market sectors, and what limits apply to different sectors.

**CM-2.9.4** Exposures and limits for sectors must be reviewed at least quarterly by the Board of Directors.

**CM-2.9.5** Bahraini conventional bank licensees which have over 10 percent 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-2 The Monitoring and Control of Large Exposures

## CM-2.10 Major Investments

### *Prior approval for Major Investments*

**CM-2.10.1** Bahraini conventional bank licensees must obtain the CBB's prior written approval before making an investment in another commercial or financial entity (whether incorporated inside or outside of Bahrain) which falls within the definition of a major investment. Additionally, the CBB's prior approval must be obtained for any subsequent increases in the licensee's ownership in excess of 5% of similar exposure. Where the increase is due to a revaluation or change in capital of the licensee, a written notification outlining the percentage increase and reasons for the increase must be provided to the CBB.

CM-2.10.2 In assessing a proposed major investment, the CBB will take into account the impact of such investment on the risk profile of the licensee. See Appendix CM-5 for criteria for assessment.

**CM-2.10.3** A major investment is defined as either of the following:

- (a) An investment in the capital instruments of another entity (whether financial or commercial) by a Bahraini conventional bank licensee which is equivalent to or more than 10% of the Bahraini conventional bank licensee's consolidated Tier 1 capital; or
- (b) An investment in the capital instruments of a non-financial entity (commercial entity) which is equivalent to or more than 10 percent of the issued common share capital of the commercial entity.

**CM-2.10.4** Any major investments by a Bahraini conventional bank licensee in the capital instruments of another entity must be included in the measure of an 'exposure' for the purposes of this Chapter, i.e. such major investments must be aggregated with all other facilities to a client for the purpose of calculating the level of 'large exposures'. Where a percentage ownership increase results in the licensee exceeding the single large exposure limit, the 800 percent risk-weight rule must be applied (see CM-2.5).

**CM-2.10.5** The CBB reserves the right to require Bahraini conventional bank licensees to dispose of any major investments acquired without its prior approval. Where a 'major investment' is acquired without the approval of the CBB, the entire value of the holding must be deducted from the consolidated total capital of the concerned licensee. Approval will not be given for 'major investments' in entities incorporated in jurisdictions where secrecy constraints exist, or there are restrictions on the passage of information to the bank (other than customer confidentiality requirements imposed by financial regulators).



<b>MODULE</b>	<b>CM: Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-2 The Monitoring and Control of Large Exposures</b>

## CM-2.10 Major Investments (Continued)

CM-2.10.6 If the licensee's close links with another entity prevent effective supervision of the licensee (or bank group), the CBB may refuse or revoke a license, or require the licensee to sell or otherwise dispose of entities within its corporate group, or to restructure the licensee.

### *Limits of major investments*

CM-2.10.7

The total amount of the licensee's investments in commercial entities, other than associated companies considered under CM-2.5.14, may not exceed the limits set forth below:

Limits on major investments in commercial entities*	Individual Limit**	Aggregate Limit**
Major investments by retail conventional bank licensees	15%	30%
Major investments by wholesale conventional bank licensees undertaking commercial banking business		40%
Major investments by wholesale conventional bank licensees undertaking investment banking business		70%

\*Exposure for this purpose includes investment in capital instruments and any other exposure to the subject entity

\*\* Limits expressed as a percentage of Total Tier 1 Capital.



MODULE	CM: Credit Risk Management
CHAPTER	CM-3 Loans to Employees

### CM-3.1 Loans to Employees

**CM-3.1.1** The CBB's prior written consent must be obtained for any loan to an employee where the amount of this 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. Conventional bank licensees must notify the CBB in writing of any senior employee who fails to discharge his repayment obligations.

**CM-3.1.2** Where a conventional bank licensee seeks the CBB's prior approval, as required under Paragraph CM-3.1.1, in its request it must confirm that the employee loan is in line with the licensee's Board-approved policy. The request must also confirm that the licensee has made an internal assessment and evaluation when reaching the decision to grant the employee loan and that all necessary internal approvals have been obtained. The licensee must also obtain the necessary credit reference information from the Bahrain Credit Reference Bureau.

**CM-3.1.3** Conventional bank licensees must ensure that the provisions of relevant laws (including, specifically, the Bahrain Labour Law) are observed at all times in this regard.



MODULE	CM:	Credit Risk Management
CHAPTER	CM-4	Write-off – Credit Facility

## CM-4.1 Write-offs

**CM-4.1.1** Bahraini conventional bank licensees must notify the CBB of any write-off of an exposure of an amount in excess of BD 100,000, or its equivalent in foreign currency.

CM-4.1.2 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-4.1.3** Bahraini conventional bank licensees must obtain the CBB's written no-objection before writing-off any of the following:

- (a) Exposures to, or exposures guaranteed by, any approved person of the licensee or any other CBB licensee;
- (b) Exposures to controllers, subsidiaries, associates and SSB members of the licensee;
- (c) Exposures to any business entity for which the licensee, or any of its approved persons, is a related party, such as a Board member, a shareholder owning 5 percent or more, a person assuming a managerial role, a guarantor, a SSB member, etc.; and
- (d) Exposures to any controller of another CBB licensee (as defined in Section GR-5.2 – Definition of Controller).

**CM-4.1.4** Branches of foreign bank licensees must obtain the CBB's written no-objection before writing off the exposures listed in CM-4.1.3 from (a) to (d) except for (b).

**CM-4.1.5** Bahraini conventional bank licensees must notify the CBB of any applicable exposures outlined in Paragraph CM-4.1.3 that are classified as NPLs.

CM-4.1.6 In order to comply with Sub-paragraphs CM-4.1.3 (a) and (d), conventional bank licensees should refer to the CBB register on the CBB website, which contains a list of approved persons and controllers of all CBB licensees.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-5</b>	<b>Consumer Finance</b>

## CM-5.1 Overview

- CM-5.1.1 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.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-5</b>	<b>Consumer Finance</b>

## CM-5.2 The CBB's Approach to Consumer Finance

**CM-5.2.1** Conventional bank licensees are reminded of their obligation to implement a sound internal controls framework, including an effective credit culture (as outlined in Section CM-1.2).

**CM-5.2.2** Conventional bank licensees which offer consumer finance facilities to residents of Bahrain must follow the Code of Best Practice on Consumer Credit attached as Appendix CM-2 in Part B of the Rulebook. Failure to adhere to the Code may result in enforcement action as outlined in Module EN.

**CM-5.2.3** Conventional bank licensees are also reminded of their obligations to display and communicate charges and APRs clearly (as outlined in Section BC-4.3).

CM-5.2.4 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. 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 Bahrain Association of Banks (see Appendix CM-2).

### *Ongoing Effort by the CBB*

CM-5.2.5 The CBB supervisors and examiners will also focus on licensees' implementation of the 'Code of Best Practice on Consumer Credit and Charging' in their ongoing 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-5</b>	<b>Consumer Finance</b>

### CM-5.3 Definition of Consumer Finance

#### CM-5.3.1

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-5.3.2

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.





MODULE	CM:	Credit Risk Management
CHAPTER	CM-5	Consumer Finance

#### CM-5.4 Maximum Limits

##### *Total Repayments Ratio*

**CM-5.4.1** Licensees may only provide a new consumer facility (or renew, extend or otherwise modify an existing consumer facility) for an amount so that the borrower's total monthly repayments on all their consumer finance commitments do not exceed 50 percent of their monthly gross income. This limit may only be exceeded in the circumstances described in Paragraphs CM-5.4.6 and CM-5.4.9.

**CM-5.4.2** 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, so that the spouse would also be legally liable for the obligation incurred.

**CM-5.4.3** 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, their individual circumstances must also be similarly assessed. In many cases, these reviews may require consumer finance repayments to be kept significantly below 50 percent of monthly gross income.

**CM-5.4.4** Licensees must enquire as to applicants' sources of income, their credit history, their regular outgoings and other financial commitments, including potential liabilities such as guarantees. Particular attention must be paid to housing costs (such as payments for social housing schemes). 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 must also take into account likely future trends in income and outgoings, and the impact this may have on the 50 percent ratio.

**CM-5.4.5** When factoring in credit cards into the repayment limit in Paragraph CM-5.4.1 above, licensees must include 5 percent of the credit limits available on these facilities. If the amounts outstanding (including interest) under such facilities exceed their limit, then the full amount outstanding must be included in the repayments ratio calculation. Charge cards are not included under this definition.



MODULE	CM:	Credit Risk Management
CHAPTER	CM-5	Consumer Finance

#### CM-5.4 Maximum Limits (Continued)

**CM-5.4.6** In the case of high earners – defined for these purposes as persons earning more than BHD 3,000 per month – the 50 percent limit may be relaxed, provided that the licensee has undertaken the review required in Paragraph CM-5.4.4 and is satisfied that the borrower can comfortably support a higher facility service ratio.

**CM-5.4.7** The review undertaken to satisfy requirements, as outlined in Paragraph CM-5.4.4, must be documented and made available to the CBB's examiners upon request. The documentation must include all relevant information used to support the decision to extend credit facilities. In the case of high earners who are granted a facility in excess of the 50 percent 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-5.4.8** The maximum tenor for instalment consumer finance is 7 years. In the case of any restructuring of a consumer finance facility repayable in instalments, the stated final maturity must be within 7 years from the date of the original facility. The tenor may not be extended more than twice during the period of the agreement and in any case not extended beyond the 7-year duration.

##### *Non-compliant Facilities*

**CM-5.4.9** Where a customer's monthly gross income falls (e.g. due to redundancy, disability or a similar event outside the control of the customer), the licensee 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 licensee may increase the term to assist the customer. The licensee must take account of the 50 percent limit outlined in Paragraph CM-5.4.1. Such facilities must also be identified as 'technically non-compliant'. Licensees must report to the CBB within 10 calendar days of each quarter end all facilities that remain 'technically non-compliant' as at the end of the quarter.



MODULE	CM:	Credit Risk Management
CHAPTER	CM-5	Consumer Finance

## CM-5.5 Refunds and Prepayments

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

#### CM-5.5.1

Conventional bank licensees 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:

*Refund/Adjustment*

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



<b>MODULE</b>	<b>CM: Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-6 Independent Assessments</b>

## CM-6.1 Independent assessments

**CM-6.1.1** Bahraini conventional bank licensees must ensure that their credit risk management framework is subject to independent review by a third party, other than the licensee's external auditors, when there are material changes in the Rulebook requirements or to the business conducted by the licensee and/or its risk profile.

**CM-6.1.2** Such reviews must cover, but are not limited to, the following areas:

- (a) The adequacy of internal systems and procedures for identifying, measuring, monitoring and mitigating credit risk;
- (b) The appropriateness of the procedures, processes, systems and tools for controlling credit risk;
- (c) The credit risk rating and scoring model governance;
- (d) The integrity and usefulness of management information reports on credit risk; and
- (e) The adherence to credit risk appetite and limits framework, credit risk policies and procedures and compliance with this Module.

**CM-6.1.3** Any weaknesses or problems identified in the review process must be addressed and resolved by senior management and reported to the Board in a timely and effective manner.

CM-6.1.4 Branches of foreign bank licensees are not required to undertake the assessment referred to in Paragraph CM-6.1.1 unless they have been instructed to do so by CBB.



<b>MODULE</b>	<b>CM:</b>	<b>Credit Risk Management</b>
<b>CHAPTER</b>	<b>CM-5</b>	<b>APPENDIX</b>

## Appendix CM-5

### CBB Illustrative Criteria for Assessment of Major Investments by Bahraini Conventional Bank Licensees

In assessing any proposed major investments mentioned above, the CBB will take into account the following points:

- (a) The amount of the proposed major investment relative to the existing consolidated total capital of the licensee;
- (b) Existing capital adequacy ratios on a consolidated basis and forecast ratios after the major investment has gone ahead;
- (c) The adequacy of information flows from the investee company to the concerned bank;
- (d) Experience, and fit and proper matters relating to the senior personnel associated with the proposed major investment;
- (e) Risks associated with the proposed major investment;
- (f) Disclosure and exchange of (supervisory) information (in the case of a foreign major investment);
- (g) Adequacy of host supervision (in the case of a foreign major investment);
- (h) Current investments and concentrations in exposures of the concerned bank.
- (i) The compliance of the concerned bank with the CBB's rules and regulations (e.g. reporting issues), and the adequacy of internal systems and controls;
- (j) The extent of holdings by any other shareholders (holding 5 percent or more of the capital of the concerned entity) or controllers of the concerned entity;
- (k) Whether the proposed activities are in line with the memorandum and articles of association ('MOA' and 'AOA') of the licensee;
- (l) The accounting treatment of the proposed major investment;
- (m) Whether the major investment relates to a closely-linked party, connected party, or controller in any way;
- (n) The existence of secrecy laws or constraints over supervisory access to the premises, assets, books and records of the concerned entity in which a 'major investment'<sup>2</sup> is being acquired;
- (o) The impact and extent of goodwill and intangibles upon the capital adequacy and balance sheet of the licensee on a consolidated basis; and
- (p) The licensee's existing and forecast liquidity position (as a result of the major investment) and how the major investment is to be funded (e.g. by the issuance of new capital or sale of other investments).