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| <b>MODULE</b>  | <b>CA:</b>   | <b>Capital Adequacy</b>                                                             |
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## **CA-3.1 Background**

- CA-3.1.1 Due to the nature of Islamic banking transactions, Islamic banks, as opposed to their conventional counterparts, are additionally exposed to price risk in their banking book. CBB recognizes that such risks need to be identified and measured for regulatory capital purposes.
- CA-3.1.2 Sections CA-3.2 to CA-3.8 describe the minimum capital requirements for the treatment of exposures, taking into account both credit and market risks including price risk within the banking book for each of the seven classes of Islamic financing assets.



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer

### *Introduction*

CA-3.2.1 This section sets out the minimum capital adequacy requirements to cover the transactions that are based on the Sharia rules and principles of Murabahah and Murabahah to the Purchase Orderer (MPO).

CA-3.2.2 In Murabahah and MPO, the capital adequacy requirement for credit risk refers to the risk of a counterparty not paying the agreed price of an asset to the bank. In the case of binding MPOs, the risks faced by the Islamic banks are different at the various stages of the contract.

**CA-3.2.3** This section is broadly divided into (a) Murabahah and non-binding MPO and (b) binding MPO, as the types of risk faced by the bank are different at the various stages of the contract for the two categories.

**CA-3.2.4** This classification and the distinctions between a non-binding MPO and a binding MPO are subject to the criteria and opinions set by the respective SSB of the bank or any other SSB as specified by the CBB.

**CA-3.2.5** A Murabahah contract refers to an agreement whereby the bank sells to a customer at acquisition cost (purchase price plus other direct costs) plus an agreed profit margin, a specified kind of asset that is already in its possession. An MPO contract refers to an agreement whereby the bank sells to a customer at cost (as above) plus an agreed profit margin, a specified kind of asset that has been purchased and acquired by the bank based on a Promise to Purchase (PP) by the customer which can be a binding or non-binding PP.

### *Murabahah and Non-binding MPO*

**CA-3.2.6** In a Murabahah transaction, the bank sells an asset that is already available in its possession, whereas in a MPO transaction the bank acquires an asset in anticipation that the asset will be purchased by the orderer/customer.

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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

### CA-3.2.7

This price risk in Murabahah contracts ceases and is replaced by credit risk for the amount receivable from the customer following delivery of the asset. Likewise, in a non-binding MPO transaction, the bank is exposed to credit risk on the amount receivable from the customer when the latter accepts delivery and assumes ownership of the asset.

#### *Binding MPO*

CA-3.2.8 In a binding MPO, the bank has no 'long' position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The bank is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the PP, resulting in the bank selling the asset to a third party at a selling price which may be lower than the cost to the bank. The risk of selling at a loss is mitigated by securing a Hamish Jiddiyyah (HJ) (a security deposit held as collateral upon entering into agreement to purchase or agreement to lease) upon executing the PP with the customer, as commonly practised in the case of binding MPO.

#### *Collateralisation*

CA-3.2.9 As one of the CRM techniques, the bank can secure a pledge of the sold asset/underlying asset or another tangible asset ("collateralised Murabahah"). The collateralisation is not automatically provided in a Murabahah contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the Murabahah contract. The bank may employ other techniques such as pledge of deposits or a third party financial guarantee. The RW of a financial guarantor can be substituted for the RW of the purchaser provided that the guarantor has a better credit rating than the purchaser and that the guarantee is legally enforceable.

CA-3.2.10 In financing transactions that are collateralised, the pricing of the Murabahah assets and determination of the required amount of HJ would normally take into consideration the market value and forced-sale value of the assets; and the CRM would take into account of any 'haircut' applicable to the collateralised assets (if these assets are eligible collateral or acceptable to the Central Bank). Thus, fluctuations in the market value and forced sale value of the collateralised assets are dealt with under credit risk assessment. For full details of CRM techniques, and the eligibility of collateral, refer to **Section CA-4.7**.



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

### *Credit Risk*

#### *Murabahah and Non-binding MPO*

##### CA-3.2.11

The credit exposure must be measured based on accounts receivable in Murabahah (the term used herein includes MPO), which is recorded at their cash equivalent value i.e. amount due from the customers at the end of the reporting quarter less any provision for doubtful debts.

##### CA-3.2.12

The accounts receivable (net of specific provisions) amount arising from the selling of a Murabahah asset must be assigned a RW based on the credit standing of the obligor (purchaser or guarantor) as rated by an ECAI that is approved by the CBB. In case the obligor is unrated, a RW of 100% shall apply. (See Section CA-4.2).

#### *Binding MPO*

##### CA-3.2.13

In a binding MPO, the bank is exposed to default on the purchase orderer's obligation to pay fully for the asset at the agreed price. In the event of the orderer defaulting on its PP, the bank will dispose of the asset to a third party. The bank will have recourse to any HJ paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

##### CA-3.2.14

In case (a) the bank has the right to recoup any loss (as indicated in the previous paragraph) from the orderer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, (less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ, provided that the collateral is an eligible collateral or has been agreed as acceptable to the CBB). The applicable RW must be based on the standing of the obligor as rated by an ECAI that is approved by the CBB, and in the case the obligor is unrated, a RW of 100% shall apply. (See Section CA-4.2).



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## **CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)**

CA-3.2.15 In case (b) the bank has no such right, and the cost of the asset to the bank constitutes a market risk (as in the case on a non-binding MPO), but this market risk exposure is reduced by the amount of any HJ that the bank has the right to retain.

CA-3.2.16 In applying the treatment as set out in paragraph CA-3.2.14, the bank should ensure that the PP is properly documented and is legally enforceable.

**CA-3.2.17** Upon selling the asset, the accounts receivable (net of specific provisions) amount must be assigned a RW based on the credit standing of the obligor as rated by an ECAI that is approved by the CBB. In case the obligor is unrated, a RW of 100% shall apply. (See Section CA-4.2).

### ***Exclusions***

CA-3.2.18 The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in section CA-4.7) and/or (iii) any amount that is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in chapter CA-4.

### ***Assignment of Risk Weights***

CA-3.2.19 Islamic financing assets are to be categorized as per the claim categories detailed in section CA-4.2, and risk weighted accordingly. Banks should ensure that the appropriate risk weight is used based on the claim category for each transaction.

### ***Market Risk***

### ***Murabahah and Non-binding MPO***

**CA-3.2.20** In the case of an asset in possession for a Murabahah transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the bank and will be subject to price risk as per section CA-5.2. This capital charge is also applicable to assets held by a bank for incomplete non-binding MPO transactions at the end of a financial period.



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## CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)

### CA-3.2.21

Assets in possession on a 'sale or return' basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets shall attract a RW based on rating of the vendor (100% in case of unrated), subject to (a) the availability of documentation evidencing such an arrangement with the vendor, and (b) the period for returning the assets to the vendor not having been exceeded. If the above conditions are not satisfied, capital charge will be provided as per paragraph CA-3.2.20.

#### *Binding MPO*

CA-3.2.22 In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the bank as the seller is only exposed to credit risk as indicated in paragraph CA-3.1.13 above.

#### *Foreign Exchange Risk*

CA-3.2.23 If the funding of an asset purchase or the selling of an asset opens a bank to foreign exchange exposures, the relevant positions should be included in the measurement of foreign exchange risk described in **section CA-5.5**.

#### *Summary of Capital Requirement at Various Stages of the Contract*

CA-3.2.24 The following table sets out the applicable period of the contract that attracts capital charges:



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## **CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)**

### **(a) Murabahah and Non-binding MPO**

| <b>Applicable Stage of the Contract</b>                                                                         | <b>Credit RW</b>                                                                                    | <b>Market Risk Capital Charge</b> |
|-----------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------|-----------------------------------|
| Asset available for sale (asset on balance sheet)*                                                              | Not applicable                                                                                      | Price risk (15% Capital charge)   |
| Asset is sold and delivered to a customer and the selling price (accounts receivable) is due from the customer. | Based on customer's rating or 100% RW for unrated customer (see paragraphs CA-3.2.11 and CA-3.2.12) | NA                                |
| Upon full settlement of the purchase price.                                                                     | NA                                                                                                  | NA                                |

\* Also includes an asset which is in possession due to cancellation of PP by a non-binding MPO customer. Any HJ taken, if any, is not considered as eligible collateral and shall not be offset against the value of the asset.



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## **CA-3.2 Murabahah and Murabahah to the Purchase Orderer (continued)**

(b) Binding MPO

| <b>Applicable Stage of the Contract</b>                                                                                                               | <b>Credit RW</b>                                                                                                                                    | <b>Market Risk Capital Charge</b>                                                 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
| Asset available for sale (asset on balance sheet)*<br>- If the bank has legal right to recoup from the customer any loss on disposing of the asset    | Asset acquisition cost less [market value of asset if eligible as collateral (net of any haircut**) plus any HJ] x applicable RW (see chapter CA-4) | NA                                                                                |
| Asset available for sale (asset on balance sheet)*<br>- If the bank has no legal right to recoup from the customer any loss on disposing of the asset | NA                                                                                                                                                  | Price risk 15%<br>Capital charge minus HJ (if the bank has legal right to the HJ) |
| Asset is sold and delivered to a customer and the selling price (accounts receivable) is due from the customer.                                       | Based on customer's rating or 100% RW for unrated customer (see section CA-4.2)                                                                     | NA                                                                                |
| Upon full settlement of the purchase price.                                                                                                           | NA                                                                                                                                                  | NA                                                                                |

\* Also includes an asset which is in possession due to cancellation of PP by a customer.

\*\* Please refer to CRM section CA-4.7 for eligibility of collateral and application of haircuts.



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## **CA-3.3 Salam and Parallel Salam**

### ***Introduction***

- CA-3.3.1 This section sets out the minimum capital requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the Sharia rules and principles of Salam. The bank is exposed to the (a) credit (counterparty) risk of not receiving the purchased commodity after disbursing the purchase price to the seller, and (b) price risk that the bank incurs from the date of execution of a Salam contract, which is applicable throughout the period of the contract and beyond the maturity date of the contract as long as the commodity remains on the balance sheet of the bank.
- CA-3.3.2 This section is applicable to (a) Salam contracts that are executed without any Parallel Salam contracts and (b) Salam contracts that are backed by independently executed Parallel Salam contracts.
- CA-3.3.3 A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity<sup>1</sup> which is to be delivered on a specified future date in a specified quantity and quality. The bank as the buyer makes full payment of the purchase price upon execution of a Salam contract or within a subsequent period not exceeding two or three days as deemed permissible by its Sharia Supervisory Board (SSB).
- CA-3.3.4 In certain cases the bank may enter into a back-to-back contract (Parallel Salam) to sell a commodity with the same specification as the purchased commodity under a Salam contract to a party other than the original seller. The Parallel Salam allows the bank to sell the commodity for future delivery at a predetermined price (thus hedging the price risk on the original Salam contract) and protects the bank from having to take delivery of the commodity and warehousing it.
- CA-3.3.5 The non-delivery of the commodity by a Salam seller (i.e. counterparty risk) does not discharge the bank's obligations to deliver the commodity under a Parallel Salam contract, and thus exposes the bank to potential loss in obtaining the supply elsewhere.
- CA-3.3.6 The obligations of a bank under Salam and Parallel Salam are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

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<sup>1</sup> A commodity is defined as a physical product which is and can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals. The commodity may or may not be traded on an organised exchange.



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### **CA-3.3 Salam and Parallel Salam (continued)**

CA-3.3.7 In the absence of a Parallel Salam contract, a bank may sell the subject-matter of the original Salam contract in the spot market upon receipt, or, alternatively, the bank may hold the commodity in anticipation of selling it at a higher price. In the latter case, the bank is exposed to price risk on its position in the commodity until the latter is sold.

#### *Credit Risk*

##### **CA-3.3.8**

The amount paid for the purchase of a commodity based on a Salam contract shall be assigned a RW based on the credit standing of the counterparties involved in the contracts as rated by an ECAI that is approved by the CBB. If a counterparty is unrated, a RW of 100% will apply. (See Section CA-4.2).

#### *Exclusions*

##### **CA-3.3.9**

The capital requirement is to be calculated on the amount paid, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in section CA-4.7) and/or (iii) any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in chapter CA-4.

#### *Applicable Period*

CA-3.3.10 The credit RW will be applied from the date of the contract made between both parties until the maturity of the Salam contract, which is upon receipt of the purchased commodity. However, between the date of contract and disbursement of funds to the customer the exposure is a commitment (off-balance sheet) and a credit conversion factor (CCF) of 20% will be applied before applying the relevant RW.

#### *Offsetting Arrangement between Credit Exposures of Salam and Parallel Salam*

##### **CA-3.3.11**

The credit exposure amount of a Salam contract is not to be offset against the exposure amount of a Parallel Salam contract, as an obligation under one contract does not discharge an obligation to perform under the other contract.



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### CA-3.3 Salam and Parallel Salam (continued)

#### *Market Risk*

- CA-3.3.12 The price risk on the commodity exposure in Salam can be measured in two ways, either the maturity ladder approach in accordance with paragraphs CA-5.6.9 to CA-5.6.12 or price risk in accordance with paragraph CA-5.2.2.
- CA-3.3.13 The long and short positions in a commodity, which are positions of Salam and Parallel Salam, may be offset under either approach for the purpose of calculating the net open positions provided that the positions are in the same group of commodities.

#### *Foreign Exchange Risk*

- CA-3.3.14 It the funding of a commodity purchase or selling of a commodity leaves a bank open to foreign exchange exposures, the relevant positions should be included in the measures of foreign exchange risk described in section **CA-5.5**.

#### *Summary of Capital Requirement at Various Stages of the Contract*

- CA-3.3.15 The following table sets out the applicable period of the contract that attracts capital charges:



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### CA-3.3 Salam and Parallel Salam (continued)

(a) Salam with Parallel Salam

| <b>Applicable Stage of Contract</b>                                                                                                                                                          | <b>Credit RW</b>                                                                                                                                                       | <b>Market Risk Capital Charge</b>                                                                                                                                                               |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Payment of purchase price by the bank of a Salam customer                                                                                                                                    | Based on customer's rating or 100% RW for unrated customer.<br><br>No Netting of Salam exposures against parallel Salam exposures.<br><br>(See <b>section CA-4.2</b> ) | Two approaches are available.<br><br>Maturity Ladder Approach (see paragraphs CA-5.6.9 to CA-5.6.12 of <b>chapter CA-5</b> )<br><br>Price risk (see CA-5.2.2 of <b>chapter CA-5</b> )           |
| Receipt of the purchased commodity by the bank. Asset available for delivery to the customer. If the bank has legal right to recoup from the customer any loss on disposing of the asset     | Based on customer's rating or 100% RW for unrated customer.<br><br>No Netting of Salam exposures against parallel Salam exposures.<br><br>(See <b>section CA-4.2</b> ) | NA                                                                                                                                                                                              |
| Receipt of the purchased commodity by the bank. Asset available for delivery to the customer - If the bank has no legal right to recoup from the customer any loss on disposing of the asset | NA                                                                                                                                                                     | Two approaches are available.<br><br>Maturity Ladder Approach (see paragraphs CA-5.6.9 to CA-5.6.12 of <b>chapter CA-5</b> )<br><br>Price risk (see paragraph CA-5.2.2 of <b>chapter CA-5</b> ) |
| The purchased commodity is sold and delivered to the buyer and the amount is received.                                                                                                       | NA                                                                                                                                                                     | NA                                                                                                                                                                                              |



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### CA-3.3 Salam and Parallel Salam (continued)

(b) Salam without Parallel Salam

| Applicable Stage of Contract                                                                                                                                                                                              | Credit RW                                                                                                                                     | Market Risk Capital Charge                                                           |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------|
| Payment of purchase price by the bank of a Salam customer. At this stage of the contract, only one of credit or market risk is possible at the same time. To be prudent, higher of the two should be provided (not both). | The higher of the following (credit or market)<br><br>Based on customer's rating or 100% RW for unrated customer.<br><br>(See section CA-4.2) | Price risk <b>but without additional 3 %</b> . (see paragraph 5.2.2 of chapter CA-5) |
| Receipt of the purchased commodity by the bank                                                                                                                                                                            | NA                                                                                                                                            | Price risk <b>but without additional 3 %</b> . (see paragraph 5.2.2 of chapter CA-5) |
| The purchased commodity is sold and delivered to the buyer.                                                                                                                                                               | NA                                                                                                                                            | NA                                                                                   |



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## **CA-3.4 Istisna'a and Parallel Istisna'a**

### ***Introduction***

- CA-3.4.1 This section sets out the minimum capital adequacy requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the Sharia rules and principles of Istisna'a.
- CA-3.4.2 Istisna'a and parallel Istisna'a contracts would attract a risk weighting as per the credit standing of the respective counterparties (See section CA-4.2).
- CA-3.4.3 An Istisna'a contract refers to an agreement to sell to or buy from a customer, a non-existent asset which is to be manufactured or built according to the ultimate buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
- CA-3.4.4 The bank, as the seller, has the option to manufacture or build the asset on its own or to engage the services of a party other than the Istisna'a ultimate buyer as supplier or subcontractor, by entering into a Parallel Istisna'a contract (please refer to paragraph CA-3.4.12).
- CA-3.4.5 The exposures under Istisna'a involve credit and market risks, as described below. Credit exposures arise once the work is billed to the customer, while market (price) exposures arise on unbilled work-in-process (WIP).
- CA-3.4.6 There is a capital requirement to cater for the credit (counterparty) risk of the bank not receiving the selling price of the asset from the customer or project sponsor either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process.
- CA-3.4.7 This section also sets out the capital adequacy requirement to cater for the market risk that a bank incurs from the date of manufacturing or construction, which is applicable throughout the period of the contract on unbilled WIP inventory.
- CA-3.4.8 This section is applicable to both (a) Istisna'a contracts that are executed without a Parallel Istisna'a contract and (b) Istisna'a contracts that are backed by independently executed Parallel Istisna'a contracts.



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### **CA-3.4 Istisna'a and Parallel Istisna'a (continued)**

CA-3.4.9 This section makes distinctions between the two main categories of Istisna'a:

(a) **Full Recourse Istisna'a**

The receipt of the selling price by the bank is dependent on the financial strength or payment capability of the customer for the subject matter of Istisna'a, where the source of payment is derived from the various other commercial activities of the customer and is not solely dependent on the cash flows from the underlying asset/project; and

(b) **Limited and Non-recourse Istisna'a**

The receipt of the selling price by the bank is dependent partially or primarily on the amount of revenue generated by the asset being manufactured or constructed by selling its output or services to contractual or potential third party buyers. This form of Istisna'a faces "revenue risk" arising from the asset's ability to generate cash flows, instead of the creditworthiness of the customer or project sponsor.

CA-3.4.10 In full, limited and non-recourse Istisna'a contracts, the bank assumes the completion risk that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a force majeure event and unavailability of qualified personnel and reliable seller(s) or subcontractors in a Parallel Istisna'a.

CA-3.4.11 The selling price of an asset sold based on Istisna'a is agreed or determined on the contractual date and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties due to alteration or modifications to the contract or unforeseen contingencies, which is a matter for the commercial decision of the bank and can result in a lower profit margin.

CA-3.4.12 In cases where a bank enters into Parallel Istisna'a to procure an asset from a party other than the original Istisna'a customer (buyer), the price risk relating to input materials is mitigated. The bank remains exposed to the counterparty risk of the Parallel Istisna'a seller in delivering the asset on time and in accordance with the Istisna'a ultimate buyer's specifications. This is the risk of not being able to recover damages from the Parallel Istisna'a seller for the losses resulting from the breach of contract.



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## **CA-3.4 Istisna'a and Parallel Istisna'a (continued)**

CA-3.4.13 The failure of the Parallel Istisna'a seller to deliver a completed asset which meets the buyer's specifications does not discharge the bank's obligations to deliver the asset ordered under an Istisna'a contract, and thus exposes the bank to potential loss in making good the shortcomings or obtaining the supply elsewhere. The obligations of a bank under Istisna'a and Parallel Istisna'a contracts are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

### ***Credit Risk***

#### ***Full Recourse Istisna'a***

**CA-3.4.14** The receivable amount generated from the selling of an asset based on an Istisna'a contract with full recourse to the customer (buyer) shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the CBB. In case the buyer is unrated, a RW of 100% shall apply. (See section CA-4.2).

#### ***Limited and Non-Recourse Istisna'a***

**CA-3.4.15** When the project is rated by an ECAI, the RW based on the credit rating of the project is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the 'Supervisory Slotting Criteria' approach for Specialised Financing (Project Finance) as set out in section CA-4.3.

CA-3.4.16 In cases where a group of contractors are engaged in a particular project, the risk rating or weightage will follow the obligations of various contractors. If the risk is undertaken by a main contractor, the risk rating of the main contractor is to be used.

**CA-3.4.17** The limited and non-recourse Istisna'a financing structure is required to meet the characteristics as set out below in order to qualify for the treatment mentioned in paragraph CA-3.4.15 above:



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#### **CA-3.4 Istisna'a and Parallel Istisna'a (continued)**

- (a) The segregation of the project's liabilities from the balance sheet of the Istisna'a ultimate buyer (or project sponsor) from a commercial and accounting perspective which is generally achieved by having the Istisna'a contract made with a special purpose entity set up to acquire and operate the asset/project concerned;
- (b) The ultimate buyer is dependent on the income received from the assets acquired/ projects to pay the purchase price;
- (c) The contractual obligations give the manufacturer/constructor/bank a substantial degree of control over the asset and the income it generates, for example under BOT (built, operate and transfer) arrangement where the manufacturer builds a highway and collects tolls for a specified period as a consideration for the selling price; and
- (d) The primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the buyer.

CA-3.4.18 Please Note: Insurance is normally part and parcel of the project risk financing. However, it is not regarded as a credit risk mitigating technique.

##### ***Exclusions***

##### **CA-3.4.19**

The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in section CA-4.7) and/or (iii) any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in chapter CA-4.

##### **CA-3.4.20**

Any portion of an Istisna'a contract that is covered by an advanced payment shall carry a RW of 0%, or the amount of the advanced payment shall be offset against the total amount receivable or amounts owing from progress billings.

##### ***Applicable Period***

CA-3.4.21 The credit RW is to be applied from the date when the manufacturing or construction process commences and until the selling price is fully settled by the bank, either in stages and/or on the maturity of the Istisna'a contract, which is upon delivery of the manufactured asset to the Istisna'a ultimate buyer.



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## CA-3.4 Istisna'a and Parallel Istisna'a (continued)

### *Offsetting Arrangement between Credit Exposures of Istisna'a and Parallel Istisna'a*

CA-3.4.22 The credit exposure amount of an Istisna'a contract is not to be offset against the credit exposure amount of a Parallel Istisna'a contract because an obligation under one contract does not discharge an obligation to perform under the other contract.

### *Market Risk*

#### *Full Recourse Istisna'a*

##### *(a) Istisna'a with Parallel Istisna'a*

CA-3.4.23

There is no capital charge for market risk to be applied in addition to provisions in paragraphs CA-3.4.14 to CA-3.4.22 above, subject to there being no provisions in the Parallel Istisna'a contract that allow the seller to increase or vary its selling price to the bank, under unusual circumstances. Any variations in a Parallel Istisna'a contract that are reflected in the corresponding Istisna'a contract which effectively transfers the whole of the price risk to an Istisna'a customer (buyer), is also eligible for this treatment.

CA-3.4.24 However, if the seller is allowed to vary the selling price of the asset, then under the price risk will be calculated in accordance with paragraph CA-5.2.2 of chapter CA-5.

##### *(b) Istisna'a without Parallel Istisna'a*

CA-3.4.25

A capital charge of 1.6% (equivalent to a 20% RW) is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated in paragraphs CA-3.4.14 to CA-3.4.22 above.

CA-3.4.26 This inventory is held subject to the binding order of the Istisna'a buyer and is exposed to the price risk as described in CA-3.4.11.

### *Foreign Exchange Risk*

CA-3.4.27 Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel Istisna'a contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk described in section CA-5.5.



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## **CA-3.4 Istisna'a and Parallel Istisna'a (continued)**

### ***Summary of Capital Requirement at Various Stages of the Contract***

CA-3.4.28 The following tables set out the applicable period of the contract that attracts capital charges for (a) Full Recourse Istisna'a (b) Limited and Non-Recourse Istisna'a.

- (a) Full Recourse Istisna'a  
(i) Istisna'a with Parallel Istisna'a

| <b>Applicable Stage of the Contract</b>           | <b>Credit RW</b>                                                                                                                                   | <b>Market Risk Capital Charge</b>                                                                                                                                                                                            |
|---------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Unbilled work-in-progress                         | Based on ultimate buyer's rating or 100% RW for unrated buyer.                                                                                     | Nil provided that there is no provision in the Parallel Istisna'a contract that allows the seller to increase or vary the selling price.                                                                                     |
| Amount receivable after contract billings         | No netting of Istisna'a exposures against Parallel Istisna'a exposures.<br><br>(See paragraphs CA-3.4.14 to CA-3.4.22)<br><br>(See section CA-4.2) | See paragraph CA-3.4.23<br>If the seller is allowed to vary the selling price of the asset, then under the market risk treatment 15% capital charge on net long or short position plus 3% capital charge on gross positions. |
| Upon full settlement price by an Istisna'a buyer. | NA                                                                                                                                                 | NA                                                                                                                                                                                                                           |



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### CA-3.4 Istisna'a and parallel Istisna'a (continued)

(ii) Istisna'a without Parallel Istisna'a

| <b>Applicable Stage of the Contract</b>            | <b>Credit RW</b>                                                                                                                      | <b>Market Risk Capital Charge</b>                                                                              |
|----------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
| Unbilled work-in-progress                          | Based on ultimate buyer's rating or 100% RW for unrated buyer.                                                                        | 1.6% capital charge on work in progress inventory.<br><br>See relevant paragraphs under CA-3.4.25 to CA-3.4.26 |
| Progress billing to customer.                      | Based on ultimate buyer's rating or 100% RW for unrated buyer.<br><br>(See paragraphs CA-3.4.14 to CA-3.4.22)<br>(See section CA-4.2) | NA                                                                                                             |
| Upon full settlement price by and Istisna'a buyer. | NA                                                                                                                                    | NA                                                                                                             |



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### **CA-3.4 Istisna'a and parallel Istisna'a (continued)**

(b) Limited and Non-Recourse Istisna'a

Istisna'a with Parallel Istisna'a (for project finance)

| <b>Applicable Stage of the Contract</b>            | <b>Credit RW</b>                                                                                                                                                                                                                     | <b>Market Risk Capital Charge</b> |
|----------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|
| Unbilled work-in-progress                          | Based on project's ECAI rating if available or supervisory slotting criteria that ranges from 70% to 250% RW.<br><br>No netting of Istisna'a exposures against Parallel Istisna'a exposures.<br><br>(See sections CA-4.2 and CA-4.3) | NA                                |
| Amount receivable after contract billings          |                                                                                                                                                                                                                                      | NA                                |
| Upon full settlement price by and Istisna'a buyer. | NA                                                                                                                                                                                                                                   | NA                                |

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## CA-3.5 Ijarah and Ijarah Muntahia Bittamleek

### *Introduction*

- CA-3.5.1 This section sets out the minimum capital requirement to cover counterparty risk and residual value risk of leased assets, arising from a bank entering into contracts or transactions that are based on the Sharia rules and principles of Ijarah and Ijarah Muntahia Bittamleek (IMB), also known as Ijarah wa Iqtinā. The section also covers the market (price) risk of assets acquired for Ijarah and IMB.
- CA-3.5.2 In an Ijarah contract (either operating or IMB), the bank as the lessor maintains its ownership in the leased asset whilst transferring the right to use the asset, or usufruct, to an enterprise as the lessee, for an agreed period at an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the bank including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee's misconduct or negligence.
- CA-3.5.3 Thus, in both Ijarah and IMB, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease as described in paragraph CA-3.5.5 below.
- CA-3.5.4 In an IMB contract, the lessor promises to transfer its ownership of the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a) the promise is separately expressed and independent of the underlying Ijarah; or (b) a gift contract is entered into conditional upon fulfilment of all the Ijarah obligations, and thereby ownership shall be automatically transferred thereupon.
- CA-3.5.5 In both operating Ijarah and IMB, the Bank either possesses the asset before entering into a leased contract or enters into the contract based on specific description of an asset to be leased and acquired in the future before it is delivered to the lessee. This agreement to lease may be considered as binding (binding Promise to Lease (PL)) or as non-binding (non-binding PL) depending on the applicable Sharia interpretations.



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## CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

### *Operating Ijarah*

CA-3.5.6 This section sets out the minimum capital requirements to cater for the lessor's exposures to (a) the credit risk of the lessee as counterparty in servicing the lease rentals, and (b) the market (price) risk attaching to the residual value of the leased assets either at the end of the Ijarah contract or at the time of repossession upon default, i.e. the risk of losing money on the resale of the leased asset.

### *IMB*

CA-3.5.7 In IMB, once the lease contract is signed, the lessor is exposed to credit risk for the lease payments receivable from the lessee (a credit risk mitigated by the asset's value as collateral<sup>2</sup> in most cases) and to a type of operational risk in respect of the need to compensate the lessee if the asset is permanently impaired through no fault of the latter. If the leased asset is permanently impaired and is uninsured, the bank suffers a loss equal to the carrying value of the leased asset, just as it would if any of its fixed assets were permanently impaired. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such case, the price risk, if any, is already reflected in a 'haircut' to be applied to the value of the leased asset as collateral. Therefore, the price risk, if any, is not applicable in the context of the IMB.

CA-3.5.8 This section sets out the minimum capital adequacy requirement to cater for the credit risk of the lessee as counterparty with respect to servicing the lease rentals. The credit risk exposure in respect of the lease rentals is mitigated by the collateral represented by the value of the leased asset on repossession, provided that the bank is able to repossess the asset, which may be subject to doubt, especially in the case of movable assets or residential real estate. Insofar as there is doubt as to the lessor's ability to repossess the asset, the residual fair value of the asset that was assumed in fixing the lease rentals is also exposed to credit risk.

CA-3.5.9 The bank may be exposed to losses in case a lessee acquiring an asset under IMB decides not to continue with the contract. In such a case, the lessor is required to refund to the lessee the capital payments (instalments of the purchase price) that were included in the periodic lease rentals (subject to deduction of any amounts due for unpaid rentals). If the value of the repossessed asset is less than the amount to be refunded (before any such deduction), the difference constitutes a loss to the lessor. This exposes the bank as lessor to a form of market risk.

<sup>2</sup> The collateral used in the context of IMB is of the usufruct or use value of the asset, as the bank is the owner of the asset.



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### **CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)**

- CA-3.5.10 In theory, a situation could arise in which, when an IMB contract arrives at its term, the lessee decides not to exercise its option to complete the purchase by making the contractually agreed final payment (The option to purchase places no obligation on the lessee to do so.). The bank may thus be exposed to market risk, in respect of a potential loss from disposing of the asset for an amount lower than its net book value. Generally, however, the lessor's exposure in such a case would not be significant, as the option to purchase can be exercised by making a payment of a token amount and the lessee would have no reason to refrain from exercising it.
- CA-3.5.11 Moreover, the net book value of the asset at the term of the IMB (i.e. its residual fair value as assumed in fixing the lease rentals) would be zero or close to zero.

#### ***Credit Risk***

##### **CA-3.5.12**

In a binding PL, when a bank is exposed to default on the lease orderer's obligation to execute the lease contract, the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any urbun received from the lease orderer. The applicable RW shall be based on the standing of the obligor as rated by an ECAI that is approved by the CBB, and in the case the obligor is unrated, a RW of 100% shall apply (refer to chapter CA-4). The bank may or may not have the right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ.

##### **CA-3.5.13**

In applying the treatment as set out in paragraph CA-3.5.12, the bank must ensure that the PL is properly documented and is legally enforceable. In the absence of proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach as set out in paragraph CA-3.5.18(a).

#### ***Operating Ijarah***

##### **CA-3.5.14**

When the lessee gets the right to use the asset, the lessor is exposed to credit risk for the estimated value of the lease payments in respect of the remaining period of the Ijarah. This exposure is mitigated by the market value of the leased asset (subject to the applicable haircut) which may be repossessed (except in the case of residential real estate). The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In the case that the lessee is unrated, a RW of 100% shall apply.



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## CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

### *IMB*

#### CA-3.5.15

When the lessee gets the right to use the asset, the capital requirement for IMB is based on the total estimated future ijarah receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed (except in the case of residential real estate). The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In the case that the lessee is unrated, a RW of 100% shall apply. (See section CA-4.2).

#### CA-3.5.16

The estimated future ijarah receivable amount as indicated in paragraph CA-3.5.15 (a) above, shall be risk-weighted based on the credit standing of the lessee as rated by an ECAI or at 100%, after deduction of the value of the leased asset as collateral (subject to any haircut). (See chapter CA-4).

### *Exclusions*

CA-3.5.17 The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in section CA-4.7) and/or (iii) any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in chapter CA-4.

### *Market Risk*

#### CA-3.5.18

In the case of an asset acquired and held for the purpose of either operating Ijarah or IMB, the capital charge to cater for market (price) risk in respect of the leased asset from its acquisition date until its disposal can be categorised into the following:

#### (a) Non-binding PL

The asset for leasing will be treated as inventory of the bank and capital charge will be provided for the price risk in accordance with section CA-5.2.



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### **CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)**

#### **(b) Binding PL**

In a binding PL, a bank is exposed to default on the lease orderer's obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the bank will either lease or dispose of the asset to a third party. The bank will have recourse to any HJ paid by the customer<sup>3</sup>, and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession (if eligible) as well as any HJ paid by the lease orderer.

CA-3.5.19 In case (i), the bank has the right to recoup any loss (as indicated in the previous paragraph) from the customer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset's total acquisition cost to the bank, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW shall be based on the standing of the customer as rated by an ECAI that is approved by CBB, and in the case the obligor is unrated, a RW of 100% shall apply. (see section CA-4.2).

CA-3.5.20 In case (ii) the bank has no such right, and the cost of the asset to the bank constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any HJ that the bank has the right to retain.

#### ***Operating Ijarah***

##### **CA-3.5.21**

The residual value of the asset will be subject to capital charge of 8%. Upon expiry of the lease contract, the carrying value of the leased asset shall carry a capital charge for price risk in accordance with section CA-5.2 until the asset is re-leased or disposed of.

#### ***IMB***

CA-3.5.22 In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such a case, the price risk, if any, is already reflected in a 'haircut' to be applied to the value of the leased asset as collateral in credit risk. Therefore, the price risk, if any, is not applicable in the context of the IMB.

<sup>3</sup> The amount can only be deducted for damages, i.e. difference between the asset acquisition cost and the total of lease rentals (when the asset is leased to a third party) or selling price (when the asset is sold to a third party), whichever is applicable.



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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

#### *Summary of Capital Requirement at Various Stages of the Contract*

CA-3.5.23 The following tables set out the applicable period of the contract that attracts capital charges:

##### *Operating Ijarah*

| <b>Applicable Stage of the Contract</b>                                                                                                                       | <b>Credit RW</b>                                                                                                                                                                                                                                                              | <b>Market Risk Capital Charge</b>                                                                 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| Asset available for lease (prior to signing a lease contract) – If the bank has legal right to recoup from the customer any loss on disposing of the asset    | Binding PL<br>Asset acquisition cost less (a) market value of asset fulfilling function of collateral (net of any haircuts) and (b) any 'hamish jiddiyah' multiply with the customer's rating or 100% RW for unrated customer. (See section CA-4).                            | Non-binding PL<br>15% capital charge until lessee takes possession.                               |
| Asset available for lease (prior to signing a lease contract) – If the bank has no legal right to recoup from the customer any loss on disposing of the asset | NA                                                                                                                                                                                                                                                                            | 15% capital charge until lessee takes possession minus urbun (If the bank has legal right to it). |
| When the lessee gets the right to use the asset and the lease rental payments are due from the lessee                                                         | Total contractual obligation of the lease rental receivable over the duration of the lease contract less the recovery value* (if eligible) of the leased asset shall be risk-weighted according to the lessee's rating. (100% RW for an unrated lessee.). (See chapter CA-4). | The residual value will be subject to capital charge of 8%                                        |
| Maturity of contract term and the leased asset is returned to the bank                                                                                        | Not applicable                                                                                                                                                                                                                                                                | 15% capital charge of the carrying value of the asset                                             |

\* Recovery value should be based on the entire Ijarah asset value.



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### CA-3.5 Ijarah and Ijarah Muntahia Bittamleek (continued)

IMB

| Applicable Stage of the Contract                                                                                                                              | Credit RW                                                                                                                                                                                                                                                       | Market Risk Capital Charge                                                                        |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| Asset available for lease (prior to signing a lease contract) – If the bank has legal right to recoup from the customer any loss on disposing of the asset    | Binding PL<br>Asset acquisition cost less (a) market value of asset fulfilling function of collateral (net of any haircuts) and (b) any 'hamish jiddiyah' multiply with the customer's rating or 100% RW for unrated customer. (See chapter CA-4).              | Non-binding PL<br>15% capital charge until lessee takes possession                                |
| Asset available for lease (prior to signing a lease contract) – If the bank has no legal right to recoup from the customer any loss on disposing of the asset | NA                                                                                                                                                                                                                                                              | 15% capital charge until lessee takes possession minus urbun (If the bank has legal right to it). |
| When the lessee gets the right to use the asset and the lease rental payments are due from the lessee                                                         | Total contractual obligation of the lease rental receivable over the duration of the lease contract less recovery value of the asset* (if eligible) shall be risk-weighted according to the lessee's rating (100% RW for an unrated lessee. (See chapter CA-4). | Not applicable                                                                                    |
| Maturity of contract term and the leased asset is returned to the bank                                                                                        | Not applicable                                                                                                                                                                                                                                                  | Not applicable                                                                                    |

\* Recovery value should be based on the entire Ijarah asset value.

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## CA-3.6 Musharakah and Diminishing Musharakah

### *Introduction*

- CA-3.6.1 This section sets out the minimum capital adequacy requirement to cover the risk of loss on invested capital arising from entering into contracts or transactions that are based on the Sharia rules and principles of Musharakah and Diminishing Musharakah where the bank and their customers/partner(s) contribute to the capital of the partnership and shares its profit or loss.
- CA-3.6.2 This section is applicable to both (a) Musharakah in which all the partners' share remain constant throughout the contract period; and (b) Diminishing Musharakah in which the share of the bank shall be gradually reduced during the tenure of the contract until it is fully sold to the other partner(s).
- CA-3.6.3 Musharakah contracts refer to partnerships in specific transactions or projects. These exclude participation in the share capital (equity) of other enterprises.
- CA-3.6.4 A Musharakah is an agreement between the bank and a customer to contribute capital in various proportions to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a permanent basis, or on a diminishing basis where the customer progressively buys out the share of the bank ("Diminishing Musharakah"). Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharakah agreement whilst losses are shared in proportion to the respective contributor's share of capital.
- CA-3.6.5 A bank may enter into a Musharakah contract with a customer as a means of providing a financing to the latter on a profit sharing and loss bearing basis. In this case, the Musharakah is normally of the diminishing type, in which the customer gradually purchases the bank's partnership share over the life of the contract. This type of financing is one of the Sharia compliant alternatives to avoid a conventional term loan repayable by instalments, and as such it is exposed to credit risk for the customer's purchase payments as well as to the risk attached to the bank's share of the underlying assets.



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## **CA-3.6 Musharakah and Diminishing Musharakah (continued)**

### ***Musharakah***

CA-3.6.6 This section sets out the minimum capital adequacy requirement to cater for “capital impairment risk”, the risk of losing the amount contributed to an enterprise or ownership of an asset. The bank acts as a partner in a Musharakah contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a Musharakah contract. A Musharakah can expose the bank either to capital impairment risk or to ‘credit risk’, depending on the structure and purpose of the Musharakah and the types of asset in which the funds are invested. The invested capital is redeemable either by liquidation of the Musharakah assets at the end of the contract which has a fixed tenure or as mutually agreed by the partners, or upon divestment of partnership in an on-going Musharakah subject to giving a notice to other partners. The amount of capital redemption is represented by the value of a share of capital, which is dependent on the quality of the underlying investments or assets, and ability to generate profits and cash flows from the Musharakah.

CA-3.6.7 As a partner to a Musharakah contract, the bank is not entitled to a fixed rate of return and is thus exposed to variable profits generated by the partnership which are shared on a basis as agreed in the Musharakah contract, whereas losses are to be borne by the bank and its partners according to their respective ratio of invested capital. Therefore, the bank is exposed to entrepreneurial risk of an active partner that manages the partnership and business risks associated with the underlying activities and types of investments or assets of the partnership.

### ***Diminishing Musharakah***

CA-3.6.8 This form of Musharakah is a means whereby a bank can provide term finance to a client on a profit and loss sharing basis. The bank enters into this type of Musharakah with the objective of transferring the ownership to the partner/customer, where the bank acts as a joint-owner of the asset with a promise by the partner to purchase the bank’s share making a payment on one or more specified future dates. The bank’s selling price is normally based on the fair value of the partnership share being transferred on the date of each purchase, which may expose the bank to the risk of selling its share of ownership below the acquisition price.

CA-3.6.9 As a joint-owner, the bank is also entitled to its share of revenue generated from the assets of the Musharakah, such as Ijarah lease rentals in which the rental entitlements to the bank shall be adjusted periodically according to the bank’s share of ownership in the asset.



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## **CA-3.6 Musharakah and Diminishing Musharakah (continued)**

CA-3.6.10 The bank's position in a Diminishing Musharakah thus entails two kinds of exposure. The amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay, with the shares of the partner in the asset providing credit risk mitigation as collateral. The capital invested by the bank is also subject to the risk that the amounts recoverable from the partner may be less than the amount invested because the value of the Musharakah assets has decreased (capital impairment risk).

### *Equity Position Risk - Musharakah*

**CA-3.6.11** Musharakah exposures, unless deducted for regulatory capital purposes according to the Prudential Consolidation and Deduction Requirements, will be treated as stated in paragraphs CA-3.6.12 to CA-3.6.14.

**CA-3.6.12** Musharakah exposures in the nature of specialized financing will be risk-weighted as per the supervisory slotting criteria as detailed in section CA-4.3.

**CA-3.6.13** Other Musharakah exposures will be risk-weighted using the risk weights applicable to equities as explained in section CA-4.2.

**CA-3.6.14** If the bank demonstrates that a Musharakah exposure meets the definition of trading book given in chapter CA-5, capital charge will be calculated as per market risk rules detailed in chapter CA-5.

### *Equity Position Risk – Diminishing Musharakah*

**CA-3.6.15** The equity exposure in a Diminishing Musharakah contract, where the bank intends to transfer its full ownership in movable assets and working capital to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost including any share of undistributed profits) less any specific provision for impairment. The exposure shall be risk weighted according to the nature of the underlying assets as set out in paragraph CA-3.6.11 to CA-3.6.14 above. If a third party guarantee exists, to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets (if lower) for the amount of any such guarantee.



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### CA-3.6 Musharakah and Diminishing Musharakah (continued)

#### *Summary of Capital Requirement at Various Stages of the Contract*

CA-3.6.16 The following table sets out the Musharakah categories that attract capital charges:

| <b>Musharakah Category</b>                        | <b>Credit RW</b>                                                                                                                                                                                                                                    | <b>Market Risk Capital Charge</b>                                |
|---------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------|
| Specialized financing                             | <u>Supervisory slotting criteria should be applied.</u><br><br>Between 90-270% RW of the contributed amount* to the business venture based on the four categories.                                                                                  | NA                                                               |
| Other                                             | 150% RW** of the contributed amount to the business venture less any specific provisions (if there is a third party guarantee, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee, if lower). | NA                                                               |
| Musharakah meeting the definition of trading book |                                                                                                                                                                                                                                                     | As set out in the applicable market risk section (Chapter CA-5). |

\* In the case of Diminishing Musharakah, the contributed amount is based on the remaining balance of the invested amount.

\*\* 100% RW may be applied if the funds can be withdrawn by the bank at short notice of 5 working days.



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## **CA-3.7 Mudarabah**

### ***Introduction***

- CA-3.7.1 This section sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from entering into contracts or transactions that are based on the Sharia rules and principles of Mudarabah where the bank assumes the role of capital provider. This section is applicable to both restricted and unrestricted Mudarabah financing.
- CA-3.7.2 A Mudarabah is an agreement between the bank and a customer whereby the bank would contribute capital to an enterprise or activity which is to be managed by the customer as the (labour provider or) Mudarib.
- CA-3.7.3 Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudarabah agreement whilst losses are to be borne solely by the bank unless the losses are due to the Mudarib's misconduct, negligence or breach of contracted terms.
- CA-3.7.4 A Mudarabah financing can be carried out on either:
- (a) A restricted basis, where the capital provider allows the Mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures; and
  - (b) An unrestricted basis, where the capital provider allows the Mudarib to invest funds freely based on the latter's skills and expertise.
- CA-3.7.5 As the fund provider, the bank is exposed to the risk of losing its capital investment or 'capital impairment risk' upon making payment of the capital to the Mudarib. Any loss on the investment is to be borne solely by the capital provider, but is limited to the amount of his capital. Losses that are due to misconduct, negligence or breach of contractual terms, are to be borne by the Mudarib.
- CA-3.7.6 However, while it is not permissible for a Mudarib to give a guarantee against such losses, such a guarantee may be given by a third party on the basis of tabarru (donation). In such a case, the amount of the Mudarabah capital so guaranteed may be considered as subject to credit risk with a risk weighting equal to that of the guarantor.
- CA-3.7.7 In particular, such guarantees may be given when liquid funds are placed in an Islamic interbank market under a Mudarabah contract.



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## CA-3.7 Mudarabah (continued)

### *Equity Position Risk*

#### CA-3.7.8

Mudarabah exposures, unless deducted for regulatory capital purposes according to the Prudential Consolidation and Deduction Requirements, will be treated as stated in paragraphs CA-3.7.9 to CA-3.7.11.

#### CA-3.7.9

Mudarabah exposures in the nature of specialized financing will be risk-weighted as per the supervisory slotting criteria as detailed in section CA-4.3.

#### CA-3.7.10

Other Mudarabah exposures will be risk-weighted using the risk weights applicable to equities as explained in section CA-4.2.

#### CA-3.7.11

If the bank demonstrates that a Mudarabah exposure meets the definition of trading book given in chapter CA-5, capital charge will be calculated as per market risk rules detailed in chapter CA-5.



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## CA-3.7 Mudarabah (continued)

### *Summary of Capital Requirements for Mudarabah Categories*

CA-3.7.12 The following tables set out the Mudarabah categories that attract capital charges:

| <b>Mudarabah Category</b>                        | <b>Credit RW</b>                                                                                                                                                                                                                         | <b>Market Risk Capital Charge</b>                                    |
|--------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|
| Specialized financing                            | <u>Supervisory slotting method will be applied.</u><br><br>Between 90-270% RW of the contributed amount* to the business venture based on the four categories.                                                                           | NA                                                                   |
| Other                                            | 150% RW* of the contributed amount to the business venture less any specific provisions (if there is a third party guarantee, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee). | NA                                                                   |
| Mudarabah meeting the definition of trading book |                                                                                                                                                                                                                                          | As set out in the applicable market risk section (See chapter CA-5). |

\* 100% RW may be applied if the funds can be withdrawn by the bank at short notice of 5 working days.



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## **CA-3.8 Sukuk**

### ***Introduction***

- CA-3.8.1 This section sets out the minimum capital adequacy requirement to cover the credit risk and market risk arising from the holding of Sukuk.
- CA-3.8.2 This section is applicable only to Sukuk or certificates that represent the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset. This section does not cover certificates that give the holders the entitlement to receive returns on an asset of which the ownership is not transferred to the Sukuk holders.
- CA-3.8.3 Sukuk can be broadly categorised into:
- (a) Asset-based Sukuk, where the underlying assets offer fairly predictable returns to the Sukuk holders, such as in the case of Salam, Istisna'a and Ijarah (Note: the assets in question may be held by a Musharakah or Mudarabah which is securitised. This is not the same as the Musharakah or Mudarabah Sukuk mentioned below).
  - (b) Equity-based Sukuk, where the returns are determined on a profit and loss sharing in the underlying investment which does not offer fairly predictable returns (e.g. Musharakah or Mudarabah for trading purposes).
- CA-3.8.4 CBB has the discretion to specify measurement approaches as it thinks appropriate for other types of Sukuk which are not listed in this section, provided they are approved by a Sharia board.

### ***Salam Sukuk***

- CA-3.8.5 A Salam Sukuk represents fractional ownership of the capital of a Salam transaction, where the Salam capital is constituted by an advance payment to a counterparty as supplier of a commodity (the subject-matter) to be delivered at a future date. This type of Sukuk is non-tradable, since the subject-matter is considered to be a financial asset (a receivable). The gross return to the Sukuk holders consists of the margin or spread between the purchase price of the subject-matter and its selling price following delivery. In certain Sukuk issues, a third party gives an undertaking that the subject-matter will be sold at a price exceeding the purchase price by a specified margin. This may be achieved by means of a parallel Salam transaction in which a third party purchases the subject-matter for delivery on the same delivery date as in the original Salam contract.

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## CA-3.8 Sukuk (continued)

### *Istisna'a Sukuk*

- CA-3.8.6 An Istisna'a Sukuk represents a fractional share in the project financing of an undertaking to manufacture or construct an asset for a customer at a price to be paid in future instalments, the total of which equals the total face value of the Sukuk, in addition to mark-up. The Sukuk can be in the form of serial notes or certificates with different maturity dates that match the progress schedule of instalments as agreed between the buyer/customer of the asset and the manufacturer/bank. Istisna'a Sukuk are tradable as the subject-matter is considered to be a non-financial asset (work-in-process inventory).

### *Ijarah Sukuk*

- CA-3.8.7 An Ijarah Sukuk represents the holder's proportionate ownership in a leased asset where the Sukuk holders will collectively assume the rights and obligations of the lessor. The Sukuk holder will enjoy a share of the lease rental in proportionate to the ownership share in the leased asset. An Ijarah Sukuk is tradable from the issuance date as the subject-matter is a non-financial asset owned by the Sukuk holders. As a part-owner, the Ijarah Sukuk holder assumes a proportionate share of any loss if the leased asset is destroyed or of the cost of meeting the obligation to provide an alternative asset, failing which, the lessee can terminate the lease without paying future rentals.

### *Musharakah Sukuk*

- CA-3.8.8 A Musharakah Sukuk represents the direct pro-rata ownership of the holder in the assets of a private commercial enterprise or project where the subscription money is normally employed in purchasing non-liquid assets or such as real estate or moveable assets. A Musharakah Sukuk is a profit and loss sharing instrument where the exposure is of the nature of an equity position in the banking book, except in the case of investments (normally short-term) in assets for trading purposes. A Musharakah certificate can be tradable provided that non-cash and receivable assets are not less than 30% of market capitalisation.

### *Mudarabah (Muqaradah) Sukuk*

- CA-3.8.9 Sukuk holders subscribe to the certificates issued by a Mudarib and share the profit and bear any losses arising from the Mudarabah operations. The returns to the holders are dependent on the revenue generated by the underlying investment. The rule regarding tradability of the certificates is the same as for Musharakah certificates.

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## CA-3.8 Sukuk (continued)

### *Calculation of Capital Charge*

- |                  |                                                                                                                                                                                                                                                                                                                                                                               |
|------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>CA-3.8.10</b> | If the Sukuk has the characteristics of a claim (or debt) then the Sukuk should be risk weighted using its issue specific rating according to the nature of the issuer (i.e. sovereign, bank or corporate etc). If the Sukuk is unrated and has the characteristics of a claim or debt, the risk weight applicable will be based on the risk weight applicable to the issuer. |
| <b>CA-3.8.11</b> | If the Sukuk is equity in nature, such investment should be treated as an equity investment and risk weighted accordingly (i.e. 100 % for listed and 150 % for others).                                                                                                                                                                                                       |
| <b>CA-3.8.12</b> | The bank can apply to CBB for using look-through approach for such investment if it can demonstrate that look-through approach is more appropriate to the circumstances of the bank.                                                                                                                                                                                          |
| <b>CA-3.8.13</b> | If there are no voting rights attached to investment in Sukuk, the investment will not be subjected to consolidation and deduction requirements (except large exposure limit).                                                                                                                                                                                                |
| <b>CA-3.8.14</b> | For the purpose of determining “large exposure limit” for investment in Sukuk, look-through approach should be used (despite the fact that look-through approach is not used to risk weight the investment)                                                                                                                                                                   |
| <b>CA-3.8.15</b> | If the bank demonstrates that a Sukuk exposure meets the definition of trading book given in chapter CA-5, capital charge will be calculated as per market risk rules detailed in chapter CA-5.                                                                                                                                                                               |

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### CA-3.8 Sukuk (continued)

#### *Summary of Capital Requirements for Sukuk Exposures*

CA-3.8.16 The following tables summarises the capital requirements for Sukuk exposures:

| Sukuk Category                                             | Credit RW                                                                                                                                          | Market Risk Capital Charge                                           |
|------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|
| In nature of claim or debt                                 | Risk-weighted according to the external rating of the Sukuk (where rated) or according to the risk weight applicable to the issuer (where unrated) |                                                                      |
| In nature of equity - Listed                               | <u>100% RW</u>                                                                                                                                     | NA                                                                   |
| In nature of equity– Not listed                            | <u>150% RW</u>                                                                                                                                     | NA                                                                   |
| If the bank gets approval to apply “look-through approach” | <u>RWs applicable to the underlying assets</u>                                                                                                     | NA                                                                   |
| Sukuk meeting the definition of trading book               | <u>NA</u>                                                                                                                                          | As set out in the applicable market risk section (See chapter CA-5). |

\* 100% RW may also be applied if the funds can be withdrawn by the bank at short notice of 5 working days.



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## **CA-4.1 Introduction**

- CA-4.1.1 Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murabaha contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisn'a contracts and lease payments receivable in Ijarah contracts, and Sukuk held to maturity in the banking book. Credit risk is measured according to the Standardised Approach as outlined in the Basel II guidelines, except for certain exposures arising from investments by means of Musharaka or Mudaraba contracts in assets in the banking book. The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and are to be risk-weighted applying the supervisory slotting criteria for exposures in the nature of specialised financing and the risk weights applicable to equities for other equity exposures as detailed in the Musharaka and Mudaraba sections of this Rulebook.
- CA-4.1.2 Broadly, the assignment of Risk Weights (RW) under the standardised approach takes into consideration the following:
- The credit risk rating of an obligor or other counterparty, or a security, based on external credit assessment institutions (ECAI) ratings<sup>4</sup>. In determining the risk weights in the standardised approach, Islamic banks must use assessments by only those external credit assessment institutions which are recognised as eligible for capital purposes by CBB in accordance with the criteria defined in section CA-4.6.
  - Credit risk mitigation techniques adopted by the banks;
  - Types of the underlying assets that are sold and collateralised or leased by the banks; and
  - The amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.
- CA-4.1.3 Where a discount is applied on fair value of an asset (as explained in **CA-2.1.4**), the value of the asset will be adjusted to exclude that discount part. Refer to appendix CA-7.

<sup>4</sup> The notations follow the methodology used by one institution, Standard & Poor's. The use of Standard & Poor's credit ratings is an example only; those of some other external credit assessment institutions could equally well be used. The ratings used throughout this document, therefore, do not express any preferences or determinations on external assessment institutions by CBB.



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## **CA-4.2 Segregation of Claims**

### *Claims on Sovereigns*

CA-4.2.1 Claims on governments of GCC member states (hereinafter referred to as GCC) and their central banks can be risk weighted at 0%. Claims on other sovereigns and their central banks are given a preferential risk weighting of 0% where such claims are denominated and funded in the relevant domestic currency of that sovereign/central bank (e.g. if a Bahraini bank has a claim on government of Australia and the loan is denominated and funded in Australian dollar, it will be risk weighted at 0%). Such preferential risk weight for claims on GCC/other sovereigns and their central banks will be allowed only if the relevant supervisor also allows 0% risk weighting to claims on its sovereign and central bank.

#### **CA-4.2.2**

**Claims on sovereigns other than those referred to in the previous paragraph must be assigned risk weights as follows:**

| Credit Assessment | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Unrated |
|-------------------|------------|----------|--------------|-----------|----------|---------|
| Risk Weight       | 0%         | 20%      | 50%          | 100%      | 150%     | 100%    |

### *Claims on International Organizations*

#### **CA-4.2.3.**

**Claims on the Bank for International Settlements, the International Monetary Fund and the European Central Bank must receive a 0% risk weight.**

### *Claims on Non-central Government Public Sectors Entities (PSEs)*

#### **CA-4.2.4**

**Claims on the Bahraini PSEs listed in Appendix CA-8 will be treated as claims on the government of Bahrain.**

#### **CA-4.2.5**

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 as outlined in paragraphs CA-4.2.1 and CA-4.2.2 above. These PSE's must be shown on a list maintained by the concerned central bank or financial regulator. Where PSE's are not on such a list, they must be subject to the treatment outlined in paragraph CA-4.2.6 below.



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## **CA-4.2 Segregation of Claims (continued)**

### **CA-4.2.6**

Claims on all other (foreign) PSEs (i.e. not having sovereign treatment) denominated and funded in the home currency of the sovereign must be risk weighted as allowed by their home country supervisors, provided the sovereign carries rating BBB- or above. Claims on PSEs with no explicit home country weighting or to PSEs in countries of BB+ sovereign rating and below are subject to ECAI ratings as per the following table:

| Credit Assessment | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Unrated |
|-------------------|------------|----------|--------------|-----------|----------|---------|
| Risk Weight       | 20%        | 50%      | 100%         | 100%      | 150%     | 100%    |

### **CA-4.2.7**

Claims on commercial companies owned by governments must be risk weighted as normal commercial entities unless they are covered by a government guarantee that satisfies the conditions in CA-4.7 below in which case they may take the risk weight of the concerned government.

#### ***Claims on Multilateral Development Banks (MDB's)***

CA-4.2.8 MDB's currently eligible for a 0% risk weight are: the World Bank Group comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IADB), the European Investment Bank (EIB), the European Investment Fund (EIF), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), the Islamic Development Bank (IDB), Arab Monetary Fund (AMF), the Council of Europe Development Bank (CEDB), the Arab Bank for Economic Development in Africa (ABEDA), Council of European Resettlement Fund (CERF) and the Kuwait Fund for Arab Economic Development (KFAED).

CA-4.2.9 The claims on MDB's, which do not qualify for the 0% risk weighting, should be assigned risk weights as follows:

| Banks Credit Quality Grades | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Un-rated |
|-----------------------------|------------|----------|--------------|-----------|----------|----------|
| Risk weights                | 20%        | 50%      | 50%          | 100%      | 150%     | 50%      |



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## CA-4.2 Segregation of Claims (continued)

### *Claims on Islamic Banks and Conventional Banks*

#### CA-4.2.10

Claims on banks must be risk weighted as given in the following table. No claim on an unrated bank may receive a risk weight lower than that applied to claims on its sovereign of incorporation (see Guidance in Paragraph CA-4.2.11A for self-liquidating letters of credit).

| Banks Credit Quality Grades | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- | Below B- | Un-rated |
|-----------------------------|------------|----------|--------------|-----------|----------|----------|
| Standard risk weights       | 20%        | 50%      | 50%          | 100%      | 150%     | 50%      |
| Preferential risk weight    | 20%        | 20%      | 20%          | 50%       | 150%     | 20%      |

CA-4.2.11 Short-term claims on locally incorporated banks may be assigned a risk weighting of 20% where such claims on the banks are of an original maturity of 3 months or less denominated and funded in either “BD or US\$. A preferential risk weight that is one category more favourable than the standard risk weighting may be assigned to claims on foreign banks licensed in Bahrain of an original maturity of 3 months or less denominated and funded in the relevant domestic currency (other than claims on banks that are rated below B-). Such preferential risk weight for short-term claims on banks licensed in other jurisdictions will be allowed only if the relevant supervisor also allows this preferential risk weighting to short-term claims on its banks.

CA-4.2.11A Self-liquidating letters of credit issued or confirmed by an unrated bank will be allowed a risk weighting of 50% or 20% without reference to the risk weight of the sovereign of incorporation. All other claims will be subject to the ‘sovereign floor’ of the country of incorporation of the concerned issuing or confirming bank.

CA-4.2.12 Claims with an (contractual) original maturity under 3 months that are expected to be rolled over (i.e. where the effective maturity is longer than 3 months) will not qualify for a preferential treatment for capital adequacy purposes.



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## **CA-4.2 Segregation of Claims (continued)**

### *Claims on Investment Firms*

#### **CA-4.2.13**

Claims on category one and category two investment firms which are subject to direct supervisory and regulatory provisions from the CBB may be treated as claims on banks for risk weighting purposes but without the use of preferential risk weight for short-term claims. Claims on category three investment firms must be treated as claims on corporates for risk weighting purposes. Claims on investment firms in other jurisdictions will be treated as claims on corporates for risk weighting purposes. However, if the bank can demonstrate that the concerned investment firm is subject to a Basel II equivalent capital adequacy regime and is treated as a bank for risk weighting purposes by its home regulator, then claims on such investment firms may be treated as claims on banks.

### *Claims on Corporates, including Insurance Companies*

#### **CA-4.2.14**

Risk weighting for corporates including insurance companies is as follows:

|                   |            |          |             |           |         |
|-------------------|------------|----------|-------------|-----------|---------|
| Credit assessment | AAA to AA- | A+ to A- | BBB+ to BB- | Below BB- | Unrated |
| Risk weight       | 20%        | 50%      | 100%        | 150%      | 100%    |

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## CA-4.2 Segregation of Claims (continued)

CA-4.2.15 Risk weighting for unrated (corporate) claims will be reviewed and where appropriate, may be increased by the CBB. Credit facilities to small/medium enterprises may be placed in the regulatory retail portfolio in limited cases below.

### *Claims included in the Regulatory Retail Portfolios*

CA-4.2.16 No claim on any unrated corporate, where said corporate originates from a foreign jurisdiction, may be given a risk weight lower than that assigned to a corporate within its own jurisdiction, and in no case will it be below 100%.

**CA-4.2.17** Retail claims that are included in the regulatory retail portfolio must be risk weighted at 75%, except as provided in CA-4.2.21 for the past due receivables.

**CA-4.2.18** To be included in the regulatory retail portfolio, claims must meet the following criteria:

- (a) **Orientation** — the exposure is to an individual person or persons or to a small business. A small business is a Bahrain-based business with annual turnover below BD 2mn.
- (b) **Product** — The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and running finance), personal term finance and leases (e.g. instalment finance, auto finance and leases, student and educational finance, personal finance) and small business facilities and commitments. Islamic products which involve securities (such as Musharakah, Mudarabah, Sukuks and equities), whether listed or not, are specifically excluded from this category. Mortgage finance will be excluded if they qualify for treatment as claims secured by residential property (see below). Finance for purchase of shares are also excluded from the regulatory retail portfolios.
- (c) **Granularity** — The regulatory retail portfolio is sufficiently diversified to a degree that it reduces the risks in the portfolio, warranting a 75% risk weight. No aggregate exposure to one counterpart<sup>5</sup> can exceed 0.2% of the overall regulatory retail portfolio.

<sup>5</sup> Aggregated exposure means gross amount (i.e. not taking any credit risk mitigation into account) of all forms of debt exposures (e.g. finances or commitments) that individually satisfy the three other criteria. In addition, “to one counterpart” means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank’s aggregated exposure on both businesses).



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## **CA-4.2 Segregation of Claims (continued)**

- (d) The maximum aggregated retail exposure to one counterpart must not exceed an absolute limit of BD 250,000.

### *Claims Secured by Residential Property*

#### **CA-4.2.19**

Lending fully secured by first mortgages on residential property that is or will be occupied by the borrower, or that is leased, must carry a risk weighting of 75%. However, if the bank can justify foreclosure or repossession for a claim, a 35% risk weight will be allowed. To get this lower risk weight the bank must obtain a satisfactory legal opinion that foreclosure or repossession is possible without any impediment.

### *Claims Secured by Commercial Real Estate*

#### **CA-4.2.20**

Claims secured by mortgages on commercial real estate are subject to a minimum of 100% risk weight. If the borrower is rated below BB-, the risk-weight corresponding to the rating must be applied.

### *Past Due Receivables*

- CA-4.2.21 In the event that accounts receivable or lease payments receivable become past due, the exposure shall be risk-weighted in accordance with the following table. The exposures should be risk weighted net of specific provisions (see CA-4.3.5 for exposures risk-weighted under Supervisory Slotting Criteria).

| Type                                                                                                                                  | RW   | % of Specific Provisions for Past Due Receivables                                    |
|---------------------------------------------------------------------------------------------------------------------------------------|------|--------------------------------------------------------------------------------------|
| Unsecured exposure (other than a qualifying residential mortgage loan) that is past due more than 90 days, net of specific provisions | 150% | Less than 20% of the outstanding receivables.                                        |
|                                                                                                                                       | 100% | At least 20% of the outstanding receivables.                                         |
| Exposure secured by RRE                                                                                                               | 100% | For receivables that are past due for more than 90 days, net of specific provisions. |

- CA-4.2.22 For the purposes of defining the secured portion of a past due loan, eligible collateral and guarantees will be the same as for credit risk mitigation purposes.
- CA-4.2.23 Past due retail loans are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion, for risk-weighting purposes.

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## CA-4.2 Segregation of Claims (continued)

### *Investments in Equities and Funds*

**CA-4.2.24** Investments in listed equities must be risk weighted at 100% while equities other than listed must be risk weighted at 150%. For risk-weighting of Sukuk, refer to Section CA-3.8.

**CA-4.2.25** Investments in funds (e.g. mutual funds, Collective Investment Undertakings etc.) must be risk weighted as follows:

- If the instrument (e.g. units) is rated, it should be risk-weighted according to its external rating (for risk-weighting, it must be treated as a “claim on corporate”);
- If not rated, such investment should be treated as an equity investment and risk weighted accordingly (i.e. 100% for listed and 150% for others);
- The bank can apply to CBB for using the look-through approach for such investments if it can demonstrate that the look-through approach is more appropriate to the circumstances of the bank;
- If there are no voting rights attached to investment in funds, the investment will not be subjected to consolidation and deduction requirements (except large exposure limits);
- For the purpose of determining “large exposure limit” for investment in funds, the look-through approach should be used (even if the look-through approach is not used to risk weight the investment).

**CA-4.2.26** CBB may enforce a bank to adopt the ‘Simple Risk Weight Method’ for equities (Section CA-4.4) if the CBB considers that bank’s equity portfolio is significant.

### *Holdings of Real Estate*

**CA-4.2.27** All holdings of real estate by banks (i.e. owned directly or by way of investments in Real Estate Companies, subsidiaries or associate companies or other arrangements such as trusts, funds or REITs) must be risk-weighted at 200%. Premises occupied by the bank may be weighted at 100%. Investments in Real Estate Companies will be subject to the materiality thresholds for commercial companies described in Module PCD and therefore any holdings which amount to 15% or more of regulatory capital will be subject to deduction. The holdings below the 15% threshold will be weighted at 200%.

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## CA-4.2 Segregation of Claims (continued)

### *Other Assets*

#### CA-4.2.28

Gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities may be treated as cash and therefore risk-weighted at 0%. In addition, cash items in the process of collection must be risk-weighted at 20%. The standard risk weight for all other assets will be 100%. Investments in regulatory capital instruments issued by banks or investment firms must be risk weighted at a minimum of 100%, unless they are deducted from the capital base according to the Prudential Consolidation and Deduction Requirements Module.

### *Underwriting of Non-trading Book items*

#### CA-4.2.29

Where a bank has acquired assets on its balance sheet in the banking book which it is intending to place with third parties under a formal arrangement and is underwriting the placement, the following risk weightings apply during the underwriting period (which may not last for more than 90 days). Once the underwriting period has expired, the usual risk weights should apply.

1. For holdings of private equity, a risk weighting of 100% will apply instead of the usual 150% (see CA-4.2.24).
2. For holdings of Real Estate, a risk weight of 100% will apply instead of the usual 200% risk weight (see CA-4.2.27).



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### CA-4.3 Supervisory Slotting Criteria

#### CA-4.3.1

Equity exposures in the nature of specialized financing will be risk-weighted as per the supervisory slotting criteria as detailed below. Specialized lending is basically a typical kind of exposure in which some special underlying assets are both the source of repayment and security. This may include financing extended to:

- Power plants, chemical processing plants, mines, transportation infrastructure, environment, telecommunications infrastructure, ships, aircraft, satellites, railcars, fleets, crude oil, metals, crops, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, hotels, High volatility real estate etc.
- Retail space;
- Multifamily residential buildings;
- Industrial or warehouse space;
- Hotels.

#### CA-4.3.2

A bank is required to map its RW into four supervisory categories as set out in the Appendix CA-1 (specialised financing) for Limited and Non-Recourse Istisna'a exposures, Mudarabah exposures, Sukuk exposures and Musharakah in a business venture exposures, where the RW for each category is as follows:

| Supervisory Categories      | Strong         | Good      | Satisfactory | Weak    |
|-----------------------------|----------------|-----------|--------------|---------|
| External Credit Assessments | BBB- or better | BB+ or BB | BB- to B+    | B to C- |
| Risk Weights                | 70%            | 90%       | 115%         | 250%    |

#### CA-4.3.3

A bank with Diminishing Musharaka exposures in real estate are required to map its RW into the four supervisory categories as set out in Appendix CA-2 (Diminishing Musharaka in real estate) where the RW of each category is as follows:

| Supervisory Categories | Strong | Good | Satisfactory | Weak |
|------------------------|--------|------|--------------|------|
| Risk Weights           | 90%    | 110% | 135%         | 270% |

#### CA-4.3.4

The above RW under the slotting criteria for specialised financing include an additional fixed factor, equal to a 20% RW, to cater for the potential decline in the Musharakah's net asset value.



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### **CA-4.3 Supervisory Slotting Criteria (continued)**

- CA-4.3.5 If any exposure which is to be risk-weighted under this sub-section becomes past due, it will be risk-weighted at the higher of risk-weight applicable under CA-4.2.21 or the risk-weight applicable under this sub-section e.g. if an exposure getting 90% risk-weight under CA-4.3.2 above becomes past due, it will be risk-weighted under CA-4.2.21 (at 100% or 150% whichever is applicable). However if an exposure getting 250% risk-weight under CA-4.3.2 above becomes past due, it will continue to be risk-weighted at 250%.



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#### CA-4.4 Simple Risk-weight Method

##### CA-4.4.1

As stated in CA-4.2.26, CBB may enforce a bank to adopt this treatment for equities if the CBB considers that bank's equity portfolio is significant.

##### CA-4.4.2

The RW under simple risk weight method for equity position risk in respect of an equity exposure shall be 300% for listed and 400% for others less any specific provisions for impairment. If there is a third party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.



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## **CA-4.5 Risk Weighting – Off-balance-sheet Items**

**CA-4.5.1** Off-balance-sheet items must be converted into credit exposure equivalents using credit conversion factors (CCFs).

**CA-4.5.2** Commitments with an original maturity of up to one year and commitments with an original maturity of over one year will receive a CCF of 20% and 50%, respectively.

CA-4.5.3 Any commitments that are unconditionally cancellable at any time by the bank without prior notice, or that are subject to automatic cancellation due to deterioration in a borrowers' creditworthiness, will receive a 0% CCF.

**CA-4.5.4** A CCF of 100% must be applied to the lending of banks' securities or the posting of securities as collateral by banks.

**CA-4.5.5** For short-term self-liquidating trade letters of credit arising from the movement of goods a 20% CCF must be applied to both issuing and confirming banks.

**CA-4.5.6** Where there is an undertaking to provide a commitment on an off-balance sheet item, banks are to apply the lower of the two applicable CCF's.

**CA-4.5.7** Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for finance and securities) and acceptances (including endorsements with the character of acceptances) must be applied a CCF of 100%.

**CA-4.5.8** Sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the bank, must be applied a CCF of 100%.

**CA-4.5.9** Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown must be applied a CCF of 100%.

**CA-4.5.10** Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) must be applied a CCF of 50%.

**CA-4.5.11** Note issuance facilities and revolving underwriting facilities must be applied a CCF of 50%.



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## CA-4.5 Risk Weighting – Off-balance-sheet Items (continued)

### CA-4.5.12

Banks must closely monitor securities, commodities, and foreign exchange transactions that have failed, starting the first day they fail. A capital charge to failed transactions must be calculated in accordance with CBB guidelines set forth in Appendix CA-5 – ‘Capital treatment for failed trades and non DvP transactions’.

### CA-4.5.13

With regard to unsettled securities, commodities, and foreign exchange transactions, banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis.

### CA-4.5.14

Furthermore, when such transactions are not processed through a delivery-versus-payment (DvP) or payment-versus-payment (PvP) mechanism, banks must calculate a capital charge as set forth in **Appendix CA-5**.

**Please Note:** An import or export financing, which is based on Murabahah where the underlying goods/shipment are collateralised and insured, shall attract a 20% credit conversion factor to the banks that issues or confirms the letter of credit. This treatment of collateral assumes there are no obstacles to the exercise of rights over it by the issuer or confirmer (see “Pledge of assets as collateral as detailed below under Credit Risk Mitigation).



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## **CA-4.6 External Credit Assessments**

### ***The Recognition Process and Eligibility Criteria***

CA-4.6.1 CBB will assess all External Credit Assessment Institutions (ECAI) according to the six criteria below. Any failings, in whole or in part, to satisfy these to the fullest extent will result in the respective ECAI's methodology and associated resultant rating not being accepted by the CBB:

- (a) **Objectivity:** The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognized by the CBB, an assessment methodology for each market segment, including rigorous back testing, must have been established for an absolute minimum of one year and with a preference of three years;
- (b) **Independence:** An ECAI must show independence and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors, political pressure, the shareholder structure of the assessment institution or any other aspect could be seen as creating a conflict of interest;
- (c) **International access/Transparency:** The individual assessments should be available to both domestic and foreign institutions with legitimate interests and at equivalent terms. The general methodology used by the ECAI has to be publicly available;
- (d) **Disclosure:** An ECAI is required to disclose the following information: its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of a slide in the ratings of an exposure from one class to another over time;
- (e) **Resources:** An ECAI must have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments will be based on methodologies combining qualitative and quantitative approaches; and
- (f) **Credibility:** Credibility, to a certain extent, can derive from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) may be evidence of the credibility of the assessments of an ECAI. The credibility of an ECAI will also be based on the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country.

CA-4.6.2 The CBB recognizes Standard and Poor's, Moody's, Fitch IBCA, Capital Intelligence and the Islamic International Rating Agency as eligible ECAIs. With respect to the possible recognition of other rating agencies as eligible ECAIs, CBB will update this paragraph subject to the rating agencies satisfying the eligibility requirements. (See Appendix CA-6 for mapping of eligible ECAIs).



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## **CA-4.6 External Credit Assessments (continued)**

### **CA-4.6.3**

**Banks must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Banks will not be allowed to “cherry-pick” the assessments provided by different eligible ECAIs.**

#### **CA-4.6.4**

Banks must disclose ECAIs that they use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by CBB through the mapping process as well as the aggregated risk-weighted assets for each risk weight based on the assessments of each eligible ECAI.

### ***Multiple Assessments***

### **CA-4.6.5**

**If there are two assessments by eligible ECAIs chosen by a bank which map into different risk weights, the higher risk weight must be applied.**

### **CA-4.6.6**

**If there are three or more assessments by eligible ECAIs chosen by a bank which map into different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights must be applied.**

### ***Issuer Versus Issues Assessment***

#### **CA-4.6.7**

Where a bank invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where the bank's claim is not an investment in a specific assessed issue, the following general principles apply:

- (a) In circumstances where the borrower has a specific assessment for an issued debt — but the bank's claim is not an investment in this particular debt — a high quality credit assessment (one which maps into a risk weight lower than that which applies to an unrated claim) on that specific debt may only be applied to the bank's un-assessed claim if this claim ranks pari passu or senior to the claim with an assessment in all respects. If not, the credit assessment cannot be used and the un-assessed claim will receive the risk weight for unrated claims; and
- (b) In circumstances where the borrower has an issuer assessment, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a high quality issuer assessment. Other un-assessed claims of a highly assessed issuer will be treated as unrated. If either the issuer or a single issue has a low quality assessment (mapping into a risk weight equal to or higher than that which applies to unrated claims), an un-assessed claim on the same counterparty will be assigned the same risk weight as is applicable to the low quality assessment.



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## **CA-4.6 External Credit Assessments (continued)**

CA-4.6.8 Whether the bank intends to rely on an issuer- or an issue-specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it.<sup>6</sup>

CA-4.6.9 In order to avoid any double counting of credit enhancement factors, no recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating (see paragraph CA-4.7.3).

### ***Domestic Currency and Foreign Currency Assessments***

CA-4.6.10 Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, the general rule is that foreign currency ratings would be used for exposures in foreign currency. Domestic currency ratings, if separate, would only be used to risk weight claims denominated in the domestic currency.

CA-4.6.11 However, when an exposure arises through a bank's participation in a loan that has been extended, or has been guaranteed against convertibility and transfer risk, by certain MDBs, its convertibility and transfer risk can be considered by CBB, on a case by case basis, to be effectively mitigated. To qualify, MDBs must have preferred creditor status recognised in the market and be included in MDB's qualifying for 0% risk rate under CA-4.2.8. In such cases, for risk weighting purposes, the borrower's domestic currency rating may be used instead of its foreign currency rating. In the case of a guarantee against convertibility and transfer risk, the local currency rating can be used only for the portion that has been guaranteed. The portion of the loan not benefiting from such a guarantee will be risk-weighted based on the foreign currency rating.

### ***Short-term/Long-term Assessments***

CA-4.6.12 For risk-weighting purposes, short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims, except under the conditions of paragraph CA-4.6.14. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates. The table below provides a framework for banks' exposures to specific short-term facilities, such as a particular issuance of commercial paper: For any Sharia contract with an original maturity of up to three months that is not rolled over, the short-term RW as set out in the following table shall be applied.

<sup>6</sup> For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.



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## **CA-4.6 External Credit Assessments (continued)**

| <b>Credit assessment</b> | <b>A-1/P-1<sup>7</sup></b> | <b>A-2/P-2</b> | <b>A-3/P-3</b> | <b>Others<sup>8</sup></b> |
|--------------------------|----------------------------|----------------|----------------|---------------------------|
| <b>Risk weight</b>       | 20%                        | 50%            | 100%           | 150%                      |

CA-4.6.13 If a short-term rated facility attracts a 50% risk-weight, unrated short-term claims cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-term, should also receive a 150% risk weight, unless the bank uses recognised credit risk mitigation techniques for such claims.

CA-4.6.14 For short-term claims on banks, the interaction with specific short-term assessments is expected to be the following:

- (a) The general preferential treatment for short-term claims, as defined under paragraphs CA-4.2.11 and CA-4.2.12, applies to all claims on banks of up to three months original maturity when there is no specific short-term claim assessment.
- (b) When there is a short-term assessment and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. Other short-term claims would benefit from the general preferential treatment.
- (c) When a specific short-term assessment for a short term claim on a bank maps into a less favourable (higher) risk weight, the general short-term preferential treatment for inter-bank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

CA-4.6.15 When a short-term assessment is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognising ECAIs as presented in paragraph CA-4.6.1 in terms of its short-term assessment.

### ***Level of Application of the Assessment***

#### **CA-4.6.16**

**External assessments for one entity within a corporate group must not be used to risk weight other entities within the same group.**

<sup>7</sup> The notations follow the methodology used by Standard & Poor's and by Moody's Investors Service. The A-1 rating of Standard & Poor's includes both A-1+ and A-1-.

<sup>8</sup> This category includes all non-prime and B or C ratings.



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## **CA-4.6 External Credit Assessments (continued)**

### ***Unsolicited Ratings***

- CA-4.6.17 As a general rule, banks should use solicited ratings from eligible ECAs but they are also allowed to use unsolicited ratings in the same way as solicited ratings. However, there may be the potential for ECAs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. If such behaviour is identified, CBB may disallow the use of unsolicited ratings.

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## C.A-4.7 Credit Risk Mitigation

CA-4.7.1 The exposure in respect of an obligor or other, counterparty can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by Islamic banks (off-balance sheet items will first be converted into on-balance sheet equivalents prior to the CRM being applied). Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised by first priority claims, in whole or in part with cash or securities or an exposure may be guaranteed by a third party. Additionally banks may agree to net exposure amounts owed to them against deposits from the same counterparty.

### *General Remarks*

CA-4.7.2 No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

**CA-4.7.3 The effects of CRM will not be double counted. Therefore, no additional recognition of CRM for regulatory capital purposes will be applicable on claims for which an issue-specific rating is used that already reflects that CRM. As stated in paragraph CA-4.6.8 of the section on the standardised approach, principal-only ratings will also not be allowed within the framework of CRM.**

CA-4.7.4 While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where these risks are not adequately controlled, the CBB may impose additional capital charges or take supervisory actions.

CA-4.7.5 Market Discipline requirements must also be observed for banks to obtain capital relief in respect of any CRM techniques.

### *Legal Certainty*

**CA-4.7.6 In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met.**

**CA-4.7.7 All documentation used in collateralised transactions and for documenting on- balance sheet netting and guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.**

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## CA-4.7 Credit Risk Mitigation (continued)

### *CRM Techniques*

The CRM techniques that are commonly employed by the bank are as follows:

#### *Hamish Jiddiyyah (Security Deposit held as Collateral)*

CA-4.7.8 Hamish Jiddiyyah (HJ), a refundable security deposit taken by the bank prior to establishing a contract, carries a limited recourse to the extent of damages incurred by the bank when the purchase orderer fails to honour a binding promise to purchase (PP) or promise to lease (PL). The bank has recourse to the clients in the PP/PL if the HJ is insufficient to cover for the damages.

CA-4.7.9 In the case of a non-binding PP/PL, the HJ shall be refunded in full to the clients, and hence is not considered as an eligible CRM.

#### *Urbun (Earnest Money held after a Contract is Established as Collateral to Guarantee Contract Performance)*

CA-4.7.10 The urbun taken from a purchaser or lessee when a contract is established accrues to the benefit of the bank if the purchaser or lessee breaches the contract within the agreed upon term.

#### *Guarantee from a Third Party (Recourse or Non-recourse Guarantee)*

CA-4.7.11 The guarantor may or may not have recourse to the debtor (i.e. purchaser or lessee) and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. However, a claim should first be made against the debtor, and then against the guarantor, unless an option is provided to make the claim against either the debtor or the guarantor.

CA-4.7.12 The guarantee can also be given in a 'blanket' form that covers an unknown amount or a future receivable. However, this type of guarantee (sometimes known as a "market/business guarantee" or "guarantee of contractual obligation") is revocable at any time prior to the existence of the future receivables and does not qualify as an eligible CRM.

#### *Leased Assets used as Collateral*

CA-4.7.13 Assets leased under Ijarah or IMB contracts fulfil a function similar to that of collateral, in that they may normally be repossessed by the lessor in the event of default by the lessee (see residential real estate CA-4.2.19 and below).

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## CA-4.7 Credit Risk Mitigation (continued)

- CA-4.7.14 The value of such assets may be offset against the exposure amount to the customer, subject to the regulatory haircuts under the Standard Supervisory Haircut<sup>9</sup> Approach (CA-4.7.32 onwards) for leased assets mentioned in the paragraph CA-4.7.39. Ijarah receivables which comprise Residential Real Estate do not generally satisfy the conditions laid out in Paragraph CA-4.7.23 and therefore such receivables will be weighted at 75% and the collateral will not be recognised for risk mitigation purposes. If the bank can show legal evidence that it may exercise foreclosure, a risk weighting of 35% may be applied to the lease receivable in the case of residential property occupied by the customer. Commercial real estate may be used as collateral for Ijarah transactions as long as it satisfies the criteria of paragraph CA-4.7.23 (and the supervisory haircut is then applied).
- CA-4.7.15 The leased asset to be used as collateral must be a Sharia compliant tangible asset of monetary value that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance.
- CA-4.7.16 The collateralisation under the concept of “rahn” or “kafālah” shall be properly documented in a security agreement or, in the body of a contract to the extent permissible by Sharia, and must be binding on all parties and legally enforceable in the relevant jurisdictions.
- CA-4.7.17 The banks must additionally document its procedures for the valuation of leased assets to be used as collateral as described above. This valuation would normally be the depreciated value of the asset as reported in the financial statement.

### ***Guarantees***

- CA-4.7.18 Capital relief for the use of a guarantee shall be given when the following conditions are satisfied:
- (a) The guarantee represents the bank’s direct claim on the guarantor;
  - (b) The guarantee is irrevocable and does not allow the guarantor to unilaterally cancel the guarantee after creation of the receivables;
  - (c) The guarantee is unconditional and provides no protection clause that prevents the guarantor from being obliged to pay out in a timely manner in the event that the original counterparty fails to make payments due;

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<sup>9</sup> The term ‘haircut’ in this context refers to a discount on the depreciated value of an asset as collateral after taking into consideration some inherent risks that affect the volatility of the market price or value of the asset. It is commonly expressed in terms of a percentage by which an asset’s value as collateral is reduced.



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## **CA-4.7 Credit Risk Mitigation (continued)**

- (d) The bank has the right to pursue, in a timely manner, the guarantor for monies outstanding, rather than having to pursue the original counterparty to recover its exposure;
- (e) The guarantee shall be an explicitly documented obligation assumed by the guarantor; and
- (f) The guarantee shall cover all types of expected payments made under the contract in the event that the original counterparty defaults.
- (g) Portions of claims guaranteed by the entities detailed in paragraph CA-4.2.1 above, where the guarantee is denominated in the domestic currency (and US\$ in case of a guarantee provided by the Government of Bahrain and CBB) may get a 0% risk-weighting. A claim may be covered by a guarantee that is indirectly counter-guaranteed by such entities. Such a claim may be treated as covered by a sovereign guarantee provided that:
  - the sovereign counter-guarantee covers all credit risk elements of the claim;
  - both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counter-guarantee need not be direct and explicit to the original claim; and
  - CBB is satisfied that the cover is robust and that no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

**Please Note:** Though insurance is normally part and parcel of the project risk financing, it is not regarded by CBB as a credit risk mitigation technique.

### ***Collateralised Transactions***

- CA-4.7.19 Where banks take eligible financial collateral as defined in paragraph CA.4.7.28, they are allowed to reduce their credit exposure to a counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral (except residential real estate – see CA-4.7.14).

### ***Overall Framework and Minimum Conditions***

- CA-4.7.20 Banks may opt for either the simple approach, which substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralised portion of the exposure (generally subject to a 20% floor), or for the standard supervisory haircuts approach which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral.

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## **CA-4.7 Credit Risk Mitigation (continued)**

- CA-4.7.21 Banks may operate under either, but not both, approaches in the banking book, but only under the standard supervisory haircuts approach in the trading book. Partial collateralisation is recognised in both approaches. Mismatches in the maturity of the underlying exposure and the collateral will only be allowed under the standard supervisory haircuts approach.
- CA-4.7.22 However, before capital relief will be granted in respect of any form of collateral, the standards set out below in paragraphs CA-4.7.23 to CA-4.7.26 must be met under either approach.

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## CA-4.7 Credit Risk Mitigation (continued)

### CA-4.7.23

In addition to the general requirements for legal certainty set out in paragraphs CA-4.7.6 and CA-4.7.7, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore banks must take all steps necessary to fulfil those requirements under the law applicable to the bank's interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral.

### CA-4.7.24

In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty — or by any related group entity — would provide little protection and so would be ineligible.

### CA-4.7.25

Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

### CA-4.7.26

Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

### *Types of Collateral*

CA-4.7.27 The types of collateral given in the next paragraph are eligible for relief in respect of the above CRM techniques.

CA-4.7.28

- (a) Hamish jiddiyyah (security deposit) only for agreements to purchase or lease preceded by a binding promise.
- (b) Urbun
- (c) Profit sharing investment account or cash on deposit<sup>10</sup> with the bank which is incurring the exposure

<sup>10</sup> Must be supported by an agreement or documentation that gives bank the right of set-off against the amount of receivables due.



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#### **CA-4.7 Credit Risk Mitigation (continued)**

- (d) Sukuk rated by an external rating agency which is issued by:
  - (i) Sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or
  - (ii) Issuers other than the above, with a minimum rating of BBB- or A-3 / P-3.
- (e) Sukuk that is unrated by an ECAI but fulfil each of the following criteria:
  - (i) Issued by an Islamic bank or a conventional bank or a sovereign;
  - (ii) Listed on a recognised exchange;
  - (iii) All other rated issues by the Islamic bank or conventional bank of the same seniority of at least BBB - or A-3/P-3 by a recognised ECAI, as determined by the CBB;
  - (iv) The Islamic bank which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3; and
  - (v) The CBB is sufficiently confident about the market liquidity of the securities.
- (f) Equities and units in collective investment schemes.
- (g) Guarantees issued by third parties that fall within the following categories:
  - (i) Sovereigns and central banks;
  - (ii) PSEs;
  - (iii) MDBs;
  - (iv) International organisations/official entities with 0% RW
  - (v) Islamic banks or conventional banks; and
  - (vi) Corporate entities (including insurance and securities firms) either by the parent, subsidiary and affiliates, of a minimum rating of A-.
- (h) Leased assets as stated under “Leased assets used as collateral” above.
- (i) Collateral under “Murabaha” accepted by CBB (see paragraphs CA-3.2.10 and CA-3.2.14).

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## **CA-4.7 Credit Risk Mitigation (continued)**

CA-4.7.29 Any portion of the exposure which is not collateralised shall be assigned the RW of the counterparty.

CA-4.7.30 As stated earlier, banks may opt for either of the two approaches listed below:

### ***The Simple Approach***

CA-4.7.31 In the simple approach the risk weighting of the collateral instrument collateralising or partially collateralising the exposure is substituted for the risk weighting of the counterparty.

### ***The Standard Supervisory Haircuts Approach***

CA-4.7.32 In this approach, when taking collateral, banks must calculate their adjusted exposure to a counterparty for capital adequacy purposes in order to take account of the effects of that collateral. Using haircuts, banks are required to adjust both the amount of the exposure to the counterparty and the value of any collateral received in support of that counterparty to take account of possible future fluctuations in the value of either<sup>11</sup>, occasioned by market movements. This will produce volatility adjusted amounts for both exposure and collateral. Unless either side of the transaction is cash, the volatility adjusted amount for the exposure will be higher than the exposure and for the collateral it will be lower.

CA-4.7.33 Additionally where the exposure and collateral are held in different currencies an additional downwards adjustment must be made to the volatility adjusted collateral amount to take account of possible future fluctuations in exchange rates.

CA-4.7.34 Where the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount (including any further adjustment for foreign exchange risk), banks shall calculate their risk-weighted assets as the difference between the two multiplied by the risk weight of the counterparty. The framework for performing these calculations is set out in paragraphs CA-4.7.36 to CA-4.7.38.

CA-4.7.35 Banks must use standard supervisory haircuts given in paragraph CA-4.7.39.

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<sup>11</sup> Exposure amounts may vary where, for example, securities are being lent.

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## CA-4.7 Credit Risk Mitigation (continued)

### *Calculation of Capital Requirement Employing the Standard Supervisory Haircuts*

CA-4.7.36 For a collateralised transaction, the exposure amount after risk mitigation is calculated as follows:

$$E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$$

where:

- E\* = the exposure value after risk mitigation
- E = current value of the exposure
- H<sub>e</sub> = haircut appropriate to the exposure
- C = the current value of the collateral received
- H<sub>c</sub> = haircut appropriate to the collateral
- H<sub>fx</sub> = haircut appropriate for currency mismatch between the collateral and exposure

#### CA-4.7.37

The exposure amount after risk mitigation will be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralised transaction. The treatment for transactions where there is a mismatch between the maturity of the counterparty exposure and the collateral is given in paragraphs CA-4.7.47 to CA-4.7.50.

CA-4.7.38 Where the collateral is a basket of assets, the haircut on the basket will be  $H = \sum_i a_i H_i$ , where  $a_i$  is the weight of the asset (as measured by units of currency) in the  $i$  basket and  $H_i$  the haircut applicable to that asset.



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## CA-4.7 Credit Risk Mitigation (continued)

### *The Standard Supervisory Haircuts*

CA-4.7.39 Both the amount of exposure to counterparty and the value of collateral received are adjusted by using standard supervisory haircuts as set out below:

| Types of Collateral*                                                                               | Residual Maturity (yrs) | Haircuts (%)                                |                                             |
|----------------------------------------------------------------------------------------------------|-------------------------|---------------------------------------------|---------------------------------------------|
|                                                                                                    |                         | Sovereigns <sup>12</sup>                    | Others                                      |
| Cash                                                                                               | All                     | 0                                           | 0                                           |
| Sukuk                                                                                              | ≤ 1                     | 0.5                                         | 1                                           |
| Long-term: AAA to AA- and                                                                          | > 1 to ≤ 5              | 2                                           | 4                                           |
| Short-term: A-1                                                                                    | > 5                     | 4                                           | 8                                           |
| Sukuk                                                                                              | ≤ 1                     | 1                                           | 2                                           |
| Long-term: A+ to BBB- and                                                                          | > 1 to ≤ 5              | 3                                           | 6                                           |
| Short-term: A-2 to A-3                                                                             | > 5                     | 6                                           | 12                                          |
| Sukuk                                                                                              | All                     | 15                                          | 15                                          |
| Long-term: BB+ to BB-                                                                              |                         |                                             |                                             |
| Sukuk (unrated)                                                                                    | All                     | 25                                          | 25                                          |
| Equities (included in main index)                                                                  | All                     | 15                                          | 15                                          |
| Equities (not included in main index but listed)                                                   | All                     | 25                                          | 25                                          |
| Units in collective investment schemes                                                             | All                     | Depending on the underlying assets as above | Depending on the underlying assets as above |
| Leased assets used as collateral (except residential real estate - see CA-4.2.19) and other assets | All                     | ≥30                                         | ≥30                                         |

\* Collateral denominated in different currency will also be subject to additional 8% haircut to cater for foreign exchange risk.

CA-4.7.40 The standard haircut for currency risk where exposure and collateral are denominated in different currencies is 8% (also based on a 10-business day holding period and daily mark-to-market). For transactions in which the bank lends non-eligible instruments (e.g. non- investment grade securities), the haircut to be applied on the exposure should be the same as the one for equity traded on a recognised exchange that is not part of a main index.

<sup>12</sup> Includes PSEs and MDBs

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## **CA-4.7 Credit Risk Mitigation (continued)**

### *The Simple Approach*

#### *The Minimum Conditions*

- CA-4.7.41 For collateral to be recognised in the simple approach, the collateral must be pledged for at least the life of the exposure and it must be marked to market and revalued with a minimum frequency of six months. Those portions of claims collateralised by the market value of recognised collateral receive the risk weight applicable to the collateral instrument. The risk weight on the collateralised portion will be subject to a floor of 20% except under the conditions specified in paragraphs CA-4.7.42. The remainder of the claim should be assigned to the risk weight appropriate to the counterparty.

#### *Exceptions to the Risk Weight Floor*

- CA-4.7.42 The 20% floor for the risk weight on a collateralised transaction will not be applied and a 0% risk weight can be applied where the exposure and the collateral are denominated in the same currency, and either:
- The collateral is cash on deposit; or
  - The collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%

#### *Treatment of Pools of CRM Techniques*

- CA-4.7.43 In the case where a bank has multiple CRM techniques covering a single exposure (e.g. a bank has both collateral and guarantee partially covering an exposure), the bank will be required to subdivide the exposure into portions covered by each type of CRM technique (e.g. portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately.

#### *Credit Risk Mitigation for Mudarabah Classified as Equity Exposures*

- CA-4.7.44 A placement of funds made under a Mudarabah contract may be subject to a Sharia compliant guarantee from a third party. Such a guarantee relates only to the Mudarabah capital, not to the return. In such cases, the capital should be treated as subject to credit risk with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the Mudarib as a counterparty. Otherwise, the RW of the Mudarib shall apply.
- CA-4.7.45 In Mudarabah investment in project finance, collateralisation of the progress payments made by the ultimate customers can be used to mitigate the exposures of unsatisfactory performance by the Mudarib.

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## CA-4.7 Credit Risk Mitigation (continued)

CA-4.7.46 The bank may also place liquid funds with a central bank or another bank on a short-term Mudarabah basis in order to obtain a return on those funds. Such placements serve as an interbank market with maturities ranging from an overnight market up to three months, but the funds may be withdrawn on demand before the maturity date in which case the return is calculated proportionately on the basis of duration and amount. Although from a juristic point of view the amounts so placed do not constitute debts, since (in the absence of misconduct or negligence) Mudarabah capital does not constitute a liability for the institution that acts as Mudarib, in practice the operation of this interbank market requires that the Mudarib should effectively treat them as liabilities. Hence a bank placing funds on this basis may treat them as cash equivalents and, for risk weighting purposes, apply the risk weight applicable to the Mudarib as counterparty.

### *Maturity Mismatches*

CA-4.7.47 For the purposes of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of CRM is less than that of the underlying exposure.

CA-4.7.48 The maturity of the underlying exposure and the maturity of the CRM should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period.

CA-4.7.49 CRM with maturity mismatches are only recognised when their original maturities are greater than or equal to one year. As a result, the maturity of CRM for exposures with original maturities of less than one year must be matched to be recognised. In all cases, CRM with maturity mismatches will no longer be recognised when they have a residual maturity of three months or less.

CA-4.7.50 When there is a maturity mismatch with recognised credit risk mitigants, the following adjustment will be applied.

$$P_a = P \times (t - 0.25) / (T - 0.25)$$

where:

$P_a$  = value of the credit protection adjusted for maturity mismatch

$P$  = credit protection (e.g. collateral amount, guarantee amount) adjusted for any haircuts

$t$  = min ( $T$ , residual maturity of the credit protection arrangement) expressed in years

$T$  = min (5, residual maturity of the exposure) expressed in years.