



## **1. GENERAL**

### **1.1. Introduction**

The purpose of this IBB Module is to establish the prudential framework for Authorised Firms carrying out Islamic Banking Business, Providing Islamic Financing or carrying out other Regulated Activities which involve assuming prudential risks by way of employing Islamic Financial Contracts. These rules are based on:

- (a) the standards and guidelines issued by the Islamic Financial Services Board on Capital adequacy;
- (b) the Basel Accords; and
- (c) the Basel Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision.

### **1.2. Commencement**

These rules commence on 1 January 2018.

### **1.3. Effect of definitions, notes, examples and references**

- (a) A definition in the Glossary also applies to any instructions or document made under these rules.
- (b) A note in or to these rules is explanatory and is not part of these rules. However, examples and guidance are part of these rules.
- (c) An example is not exhaustive, and may extend, but does not limit, the meaning of these rules or the particular provision of these rules to which it relates.
- (d) Unless the contrary intention appears, a reference in these rules to an accord, principle, standard or other similar instrument is a reference to that instrument as amended from time to time.

### **1.4. Islamic Banking Business**

Islamic Banking Business is defined in Schedule 1 of GEN as a Regulated Activity, which means carrying out the following activities, in a *Shari'ah*-compliant manner:

- (a) Raising, accepting and managing funds or money placements; and/or
- (b) Managing Unrestricted Profit Sharing Investment Accounts (UPSIA's); and
- (c) Providing financing or making Investments by entering as principal or agent into any Islamic Financial Contract.

#### **Guidance**

A firm that conducts any of the activities that make up Islamic Banking Business, or a combination of Islamic banking with other *Shari'ah*-compliant activities, will need to consider the extent to which its business model is subject to the prudential requirements set out in these rules. These



rules are designed to address the different risks that could arise from the broad range of business models, risk appetites and risk profiles of Islamic Banks.

For example, a firm that solely conducts the activity of dealing in investments as principal in a *Shari'ah*-compliant manner, (that is, an Islamic Broker Dealer) will need to consider the extent to which its activities in buying, selling, subscribing to or underwriting investments attract risks that are subject to the requirements of these rules. In contrast, a firm that is an Islamic bank and that also deals in investments as principal would be subject to a broader range of prudential requirements. In both examples, these rules apply in accordance with the nature, scale and complexity of an Islamic business.

### 1.5. Islamic Bank

- (1) An Authorised Firm is an Islamic Bank if it is an Islamic Financial Institution or an Islamic Window as defined in IFR Rules, which is authorised to conduct Islamic Banking Business, as defined in GEN Rules.
- (2) An Islamic Financial Institution is an Islamic Bank even if it is also authorised to conduct any other Regulated Activity. An Authorised Firm does not cease to be an Islamic Bank only because it conducts other Regulated Activities included in its authorisation (provided an Islamic Bank conducts them in accordance with *Shari'ah*).

### 1.6. Islamic Broker Dealer

- (1) An Authorised Firm is an Islamic Broker Dealer if it is an Islamic Financial Institution or an Islamic Window, that is authorised to conduct the Regulated Activity of Dealing in Investments as principal in a *Shari'ah*-compliant manner and it is not an Islamic bank.
- (2) An Islamic Broker Dealer may raise funds using Islamic Financial Contracts but must not manage UPSIAs.
- (3) An Authorised Firm is an Islamic Broker Dealer even if it is also authorised to conduct any other activity that is not Islamic Banking Business. An Authorised Firm does not cease to be an Islamic Broker Dealer only because it conducts other activities included in its authorisation.
- (4) An Islamic Broker Dealer may provide financing using Islamic Financial Contracts, if it receives the necessary authorisation from the AFSA.

### 1.7. Islamic Financing Company (IFC)

- (1) An Authorised Firm is an Islamic Financing Company (IFC) if it is an Islamic Financial Institution or an Islamic Window, that is authorised to conduct the Regulated Activity of Providing Islamic Financing and it is neither an Islamic Bank nor an Islamic Broker Dealer.
- (2) IFCs may raise funds using Islamic Financial Contracts but must not manage UPSIAs.
- (3) An Authorised Firm is an IFC even if it is also authorised to conduct any Regulated Activity other than Providing Islamic Financing. An Authorised Firm does not cease to be an IFC only because it conducts other activities included in its authorisation.
- (4) An IFC may conduct the Regulated Activity of dealing in Investments as principal using Islamic Financial Contracts, if it receives the necessary authorisation from the AFSA.



**1.8. Application of these rules—general**

- (1) Except when expressly stated otherwise, these rules apply to a Person that has, or is applying for, an authorisation to conduct Islamic Banking Business, Providing Islamic Financing or to act as an Islamic Broker Dealer.
- (2) Except when expressly stated otherwise, all references to Islamic Bank in this IBB Module include reference to Islamic Broker Dealers and Islamic Financing Companies (IFCs).
- (3) Except when expressly stated otherwise, the rules in this IBB Module apply to entities licensed to carry out Islamic Banking Business, Providing Islamic Financing and Dealing in Investments as principal in a *Shari'ah*-compliant manner.

**1.9. Application of these rules—branches**

- (1) Except when expressly stated otherwise, the rules in this IBB Module apply, *mutatis mutandis*, to an Authorised Firm carrying out Islamic Business in the form of a branch.
- (2) Chapter 4 (Capital adequacy and Capital requirements) and Chapter 5 (Capital Buffers and Other Requirements) do not apply to an Authorised Firm carrying out Islamic Banking Business in the form of a branch in so far as that Chapter would require the branch to hold Capital and Capital Conservation Buffer.
- (3) However, the AFSA may require a branch to have capital resources or to comply with any other Capital requirements if the AFSA considers it necessary or desirable to do so in the interest of effective supervision of the branch.

**1.10. Stress-testing**

In carrying out stress-testing and developing its stress-testing scenarios, an Islamic Bank must consider the IFSB's guiding principles on stress-testing for institutions offering Islamic financial services and the Basel Committee's recommended standards for stress-testing.



## **2. PRINCIPLES RELATING TO AN ISLAMIC BANKING BUSINESS**

### **2.1. Principle 1—Capital Adequacy**

An Islamic Bank must have capital, of adequate amount and appropriate quality, for the nature, scale and complexity of its business and for its risk profile.

### **2.2. Principle 2—Credit Risk and problem assets**

- (1) An Islamic Bank must have an adequate Credit Risk management policy that takes into account an Islamic Bank's risk tolerance, its risk profile and the market and macroeconomic conditions.
- (2) An Islamic Bank must have adequate policies for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

### **2.3. Principle 3—Transactions with related parties**

An Islamic Bank must enter into transactions with related parties on an arm's-length basis in order to avoid conflicts of interest.

### **2.4. Principle 4—Concentration risk**

An Islamic Bank must have adequate policies to identify, measure, evaluate, manage and control or mitigate concentrations of risk in a timely way.

### **2.5. Principle 5—Market Risk**

- (1) An Islamic Bank must have an adequate Market Risk management policy that takes into account an Islamic Bank's risk tolerance, its risk profile, the market and macroeconomic conditions and the risk of a significant deterioration in market liquidity.
- (2) An Islamic bank must have adequate policies to identify, measure, evaluate, manage and control or mitigate Market Risk in a timely way.

### **2.6. Principle 6—Operational risk**

- (1) An Islamic Bank must have an adequate Operational Risk management policy that takes into account an Islamic Bank's risk tolerance, its risk profile and the market and macroeconomic conditions.
- (2) An Islamic bank must have adequate policies to identify, measure, evaluate, manage and control or mitigate Operational Risk in a timely way.

### **2.7. Principle 7—Liquidity Risk**

- (1) An Islamic Bank must have prudent and appropriate quantitative and qualitative liquidity requirements. It must have policies that ensure compliance with those requirements and to manage Liquidity Risk prudently, in a manner that takes into account its risk tolerance, its risk profile and the market and macroeconomic conditions.
- (2) An Islamic Bank must have adequate policies to identify, measure, evaluate, manage and control or mitigate Liquidity Risk in a timely way.



**2.8. Principle 8—Group risk**

An Islamic Bank must effectively manage risks arising from its membership in a group.

**2.9. Principle 9—Equity participation risk**

- (1) An Islamic Bank must have an adequate equity participation risk management policy that takes into account its risk tolerance and its risk profile.
- (2) The Islamic Bank must have adequate policies to identify, measure, evaluate, manage and control or mitigate equity participation risk in a timely way (including exit strategies for its investment activities).

**2.10. Principle 10—Rate of return risk**

- (1) An Islamic Bank must have an adequate management policy for rate of return risk in the Banking Book that takes into account its risk tolerance, its risk profile and the market and macroeconomic conditions. The Islamic Bank must have policies to identify, measure, evaluate, manage and control or mitigate rate of return risk (and any resulting withdrawal risk or displaced commercial risk) in a timely way.
- (2) An Islamic Bank must have sound investment policies that are aligned with the risk and return expectations of its Profit Sharing Investment Account holders (or PSIAs), taking into consideration the distinction between restricted and unrestricted PSIAs. An Islamic Bank must be transparent in smoothing any profit pay-outs.

**2.11. Principle 11—*Shari'ah* governance and compliance**

An Islamic Bank must have a *Shari'ah* governance policy that is adequate for the nature, scale and complexity of its business and for its risk profile, and to ensure that an Islamic Bank complies with *Shari'ah*.



### **3. PRUDENTIAL REPORTING REQUIREMENTS**

#### **3.1. Introduction**

- (1) This Chapter sets out the prudential reporting requirements for an Islamic Bank.
- (2) Prudential returns of an Islamic Bank must reflect its management accounts, financial statements, risk reports or ancillary reports, as appropriate for every return. An Islamic Bank's returns, accounts, statements and reports must all be prepared using the same standards and practices, and must be easily reconcilable with one another.
- (3) A return is referred to as a solo return if it reflects one Islamic Bank's accounts, statements and reports.
- (4) A consolidated return deals with the accounts, statements and reports of an Islamic Bank consolidated with those of the other members of its Financial Group.

#### **Guidance**

Financial Group is defined in Rule 11.2 and is used for consolidated reporting instead of 'corporate group'.

#### **3.2. Information about Financial Group**

If directed by the AFSA, an Islamic Bank must give AFSA the following information about its Financial Group:

- (a) details about the entities in the group;
- (b) the structure of the group;
- (c) how the group is managed;
- (d) any other information that the AFSA requires.

#### **Guidance**

- (1) The AFSA needs to know about the following activities of the members of an Islamic Bank's Financial Group:
  - (a) regulated activities;
  - (b) activities that are not regulated activities but are financial in nature and have an effect on an Islamic Bank's supervision by the AFSA.

#### **3.3. Financial Group and risks**

- (1) If an Islamic Bank is part of a Financial Group, Credit Risk, Market Risk, Operational Risk, Liquidity Risk, equity participation risk and risk of return risk apply on a consolidated basis to that Islamic Bank and to Financial Group as a whole.
- (2) An Islamic Bank must have systems to enable it to calculate its Financial Group capital requirement and Financial Group capital resources. The Islamic Bank must ensure that its Financial Group capital resources exceed its Financial Group capital requirement, at all times.



### **3.4. Reporting to the AFSA**

- (1) An Islamic Bank must comply with the accounting and prudential reporting requirements set out in this chapter and elsewhere in this IBB Module.
- (2) The AFSA may impose additional reporting requirements on an Islamic Bank.
- (3) An Islamic Bank must prepare the prudential returns that it is required to prepare in accordance with the provisions of this IBB Module, the instructional guidelines provided by the AFSA, as specified in a notice published by the AFSA or notified by way of a directive by the AFSA.
- (4) An Islamic Bank must submit the return to the AFSA within the period stated in the notice.
- (5) The AFSA may, by written notice:
  - (a) require an Islamic Bank to prepare additional prudential returns;
  - (b) exempt an Islamic Bank from a requirement to prepare annual, biannual, quarterly or monthly returns (or a particular return); or
  - (c) extend the period within which to give a return.
- (6) An exemption referred in (b) above may be subject to one or more conditions. The Islamic Bank must comply with any condition attached to an exemption.
- (7) An Islamic Bank must submit prudential returns in accordance with the AFSA's instructions. The instructions may require that the return be prepared and/or submitted through specially designated electronic/online submission systems designated for that purpose by the AFSA.
- (8) The instructions may be set out in the return itself, in a separate document published by the AFSA on its website or by written notice.
- (9) The AFSA may by way of a written notice direct an Islamic Bank to submit its returns in a form, manner or frequency other than as prescribed in Rule 3.4.3. An Islamic Bank must continue to submit its returns in accordance with this direction until the AFSA by way of written notice directs otherwise.

### **3.5. Giving information**

- (1) The AFSA may, by written notice, require an Islamic Bank to give to it information additional to that required under these rules.
- (2) An Islamic Bank must give information to the AFSA in accordance with the instructions provided by it and within the period stated in the notice.

### **3.6. Accounts and statements to use international standards**

An Islamic Bank must prepare and keep its financial accounts and statements in accordance with accounting standards specified in GEN.

### **3.7. Signing returns**

A prudential return must be signed by the Finance Officer and the Chief Executive Officer of the Islamic Bank. If either or both of those individuals is or are unable to sign, the return must be signed by the chief risk officer of the Islamic Bank or any of its Approved Individuals.



**3.8. Notification to the AFSA**

- (1) An Islamic Bank must notify the AFSA if it becomes aware, or has reasonable grounds to believe, that an Islamic Bank has breached, or is about to breach, a prudential requirement.
- (2) In particular, the Islamic Bank must notify the AFSA as soon as practicable of:
  - (a) any breach (or foreseen breach) of its minimum capital requirement;
  - (b) any concern (including because of projected losses) it has about its Capital adequacy;
  - (c) any indication of significant adverse change in the market pricing of, or trading in, the Capital instruments of an Islamic Bank or its Financial Group (including pressure on an Islamic Bank to purchase its own equity or debt);
  - (d) any other significant adverse change in its Capital; and
  - (e) any significant departure from its ICAAP.
- (3) The Islamic Bank must also notify the AFSA about any measures taken or planned to deal with any breach, prospective breach or concern.





## **4. CAPITAL ADEQUACY**

### **4.1. General**

- (1) An Islamic Bank's total Regulatory Capital (RC) comprises of two tiers: its Tier 1 Capital and Tier 2 Capital.
- (2) Capital supports an Islamic Bank's operation by providing a buffer to absorb unexpected losses from its activities and, in the event of problems, it enables an Islamic Bank to continue to operate in a sound and viable manner while the problems are resolved. Capital management must be an integral part of an Islamic Bank's enterprise-wide risk management process and must align an Islamic Bank's risk tolerance and risk profile with its capacity to absorb losses.

### **4.2. Application to branches**

- (1) A branch is required to comply with the reporting requirements under this Chapter.

### **4.3. Governing Body's responsibilities**

- (1) This Module sets out the minimum requirements. It is the responsibility of the Governing Body of an Islamic bank to determine the adequacy of its capital. The Islamic Bank must obtain additional capital resources if its Governing Body considers that the minimum requirements do not adequately reflect the risks of its business.
- (2) The Governing Body is also responsible for:
  - (a) ensuring that Capital management is part of an Islamic Bank's overall risk management and is aligned with its risk tolerance and risk profile;
  - (b) ensuring that the Islamic Bank has, at all times, adequate capital and liquid financial resources proportionate to its risk profile and of the kinds and amounts required by these rules;
  - (c) ensuring that the Islamic Bank has Capital, of adequate amount and appropriate quality, for the nature, scale and complexity of its business and for its risk profile;
  - (d) ensuring that the amount of capital resources it meets the Regulatory Capital requirement;
  - (e) approving the Islamic Bank's ICAAP and any significant changes to it; and
  - (f) monitoring the adequacy and appropriateness of the Islamic Bank's systems and controls and the Islamic Bank's compliance with them.

### **Guidance**

- (1) An Islamic bank's risk management strategy will usually refer to risk tolerance although risk appetite may also be used. The terms 'risk tolerance' and 'risk appetite' embrace all relevant definitions used by different institutions and supervisory authorities. These 2 terms are used interchangeably to describe both the absolute risks a firm is open to take (which some may call risk appetite) and the actual limits within its risk appetite that a firm pursues (which some call risk tolerance).



- (2) If an Islamic Bank is a member of a Financial Group, the AFSA expects the capital of the Financial Group to be apportioned among the group's members, based on the allocation of risks between them.

#### **4.4. Systems and controls**

- (1) An Islamic Bank must have adequate systems and controls in place to enable it to calculate and monitor its minimum capital requirement.
- (2) The systems and controls must be documented in writing and must be appropriate for the nature, scale and complexity of its business and for its risk profile.
- (3) The systems and controls must enable an Islamic Bank to demonstrate, at all times, whether it complies with this Chapter.
- (4) The systems and controls must enable an Islamic Bank to manage available capital in anticipation of events or changes in market conditions.
- (5) The systems and controls must include ICAAP, and an Islamic Bank must have contingency arrangements to maintain or increase its capital in times of stress.

#### **4.5. *[omitted intentionally]***

#### **4.6. Initial and ongoing capital requirements**

- (1) An Islamic Bank is expected to meet minimum risk-based capital requirements for exposure to Credit Risk, Market Risk and Operational Risk. An Islamic Bank's capital adequacy ratios (consisting of CET 1 Capital ratio, Tier 1 Capital ratio and Total capital ratio), calculated by dividing relevant levels of its Regulatory Capital by total Risk-Weighted Assets.
- (2) Total Risk-Weighted Assets of an Islamic Bank is the sum of:
  - (a) an Islamic Bank's Credit Risk -weighted on-balance-sheet and off-balance-sheet items calculated in accordance with chapter 6 of this Rules; and
  - (b) 12.5 times the sum of an Islamic Bank's Market and Operational Risk Capital Requirements (to the extent that each of those requirements applies to an Islamic Bank).

#### **4.7. Base capital requirement**

The Base capital requirement is defined as:

- (a) for an Islamic Bank— USD 10 million;
- (b) for an Islamic Broker Dealer— USD 2 million; and
- (c) for an Islamic Financing Company – USD 2 million.

#### **4.8. Required Tier 1 Capital on authorisation**

- (1) An entity must have, at the time of its authorisation and at all times thereafter, CET 1 Capital of at least equal to its Base capital requirement, defined in Rule 4.7 above.



- (2) The AFSA will not grant an authorisation unless it is satisfied that the entity complies with this requirement.

#### **4.9. Required ongoing capital**

- (1) An Islamic Bank must have, at all times, Regulatory Capital which exceeds the amount of its capital requirement.
- (2) The capital requirement for an Islamic Bank is determined as the higher of the two amounts set out below:
  - (a) the applicable Base capital requirement as set out in Rule 4.7; or
  - (b) its Risk Capital Requirement as set out in Rule 4.10.
- (3) In case of an Islamic Bank whose Capital Requirement is determined by Risk Capital Requirement, and the AFSA has imposed additional Capital Requirements imposed on it, then the Capital Requirement applicable to it is determined as the sum of such additional capital requirements imposed by the AFSA and its Risk Capital Requirement.

#### **Guidance**

- (1) An Islamic Bank whose minimum Capital Requirement is its risk-based Capital Requirement is subject to the additional requirement to maintain a Capital Conservation Buffer—see rule 5.2.
- (2) The minimum amount of Regulatory Capital that a firm must have at all times is its Capital Requirement.

#### **4.10. Risk Capital Requirement**

The Risk Capital Requirement for an Islamic Bank is calculated as the sum of:

- (a) its Credit Risk Capital requirement;
- (b) its Market Risk Capital requirement; and
- (c) its Operational Risk Capital requirement.

#### **4.11. Capital adequacy ratios**

- (1) An Islamic bank's Capital adequacy is measured in terms of 3 capital ratios expressed as percentages of its total Risk-Weighted Assets (RWA).
- (2) An Islamic Bank must maintain at all times, the following capital adequacy ratios, at a minimum level of:
  - (a) 4.5% of RWA for CET 1 Capital ratio;
  - (b) 6% of RWA for Tier 1 Capital ratio; and
  - (c) 8% of RWA for Total Capital ratio.
- (3) The AFSA may, if it believes it is prudent to do so, increase any or all of a firm's minimum capital adequacy ratios. The AFSA will notify an Islamic Bank in writing about a new capital adequacy ratio and the timeframe for meeting it.



- (4) An Islamic Bank must maintain, at all times, capital adequacy ratios higher than the required minimum levels specified in Rule 4.11 (2) above, so that adequate capital is maintained in the context of the Islamic Bank's risk tolerance, risk profile and Capital Requirements, and as an additional buffer to absorb losses and preclude any potential breach of capital adequacy rules. These higher ratios are the Islamic Bank's risk-based capital adequacy ratios.

### **4.12. Elements of Regulatory Capital**

- (1) The Regulatory Capital of an Islamic Bank is the sum of its Tier 1 Capital and Tier 2 Capital.
- (2) Tier 1 Capital is the sum of an Islamic Bank's CET 1 Capital and Additional Tier 1 Capital. Tier 1 Capital is also known as going-concern capital because it is meant to absorb losses while an Islamic Bank is viable.
- (3) Tier 2 Capital is the sum of the elements set out in Rule 4.17. Tier 2 Capital is also known as gone-concern capital because it is meant to absorb losses after an Islamic Bank ceases to be viable.
- (4) For these rules, the 3 categories of Regulatory Capital are CET 1 Capital, Additional Tier 1 Capital and Tier 2 Capital.

#### **Guidance**

Funds collected or forming part of PSIAs managed by an Islamic Bank do not form part of its Regulatory Capital, because they do not satisfy the criteria for inclusion as either CET 1, Additional Tier 1 or Tier 2 Capital. Neither are the PER and IRR part of the Regulatory Capital of the Islamic Bank.

### **4.13. Common Equity Tier 1 Capital**

Common Equity Tier 1 Capital (or CET 1 Capital) is the sum of the following elements:

- (a) common shares, issued by an Islamic Bank, that satisfy the criteria in Rule 4.14 for classification as common shares (or the equivalent for non-joint stock companies);
- (b) share premium (also known as stock surplus) resulting from the issue of instruments included in CET 1 Capital;
- (c) retained earnings;
- (d) accumulated other comprehensive income and other disclosed reserves;
- (e) common shares, issued by a consolidated Subsidiary of an Islamic Bank and held by third parties, that satisfy the criteria in rule 4.23 for inclusion in CET 1 Capital;
- (f) regulatory adjustments applied in the calculation of CET 1 Capital in accordance with Rule 4.30.

#### **Guidance**

Retained earnings and other comprehensive income include appropriated profit or loss. Even though they are called reserves, the PER and IRR are not part of Tier 1 Capital of an Islamic bank. They are part of the equity of PSIA investors and, as such, do not have the requisite loss absorbency.



**4.14. Criteria for classification as common shares**

- (1) An instrument issued by an Islamic Bank is classified as a common share and included in CET 1 Capital if all of the criteria in parts (2) to (15) of this Rule are satisfied.
- (2) The instrument is the most subordinated claim in case of the liquidation of an Islamic Bank.
- (3) The holder of the instrument is entitled to a claim on the residual assets that is proportional to its share of issued capital, after all senior claims have been repaid in liquidation. The claim must be unlimited and variable and must be neither fixed nor capped.
- (4) The principal amount of the instrument is perpetual and never repayable except in liquidation. Discretionary repurchases and other discretionary means of reducing capital allowed by law do not constitute repayment.
- (5) An Islamic Bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled. The statutory or contractual terms do not provide anything that might give rise to such an expectation.
- (6) Distributions are paid out of distributable items of an Islamic Bank (including retained earnings) and the amount of distributions:
  - (a) is not tied or linked to the amount paid in at issuance; and
  - (b) is not subject to a contractual cap (except to the extent that a firm may not pay distributions that exceed the amount of its distributable items).
- (7) There are no circumstances under which the distributions are obligatory. Non-payment of distributions do not constitute default.
- (8) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. There are no preferential distributions and in particular none for any other elements classified as the highest quality issued capital.
- (9) It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality Capital, each instrument absorbs losses on a going-concern basis proportionately and equally with all the others.
- (10) The paid-in amount is recognised as equity capital (rather than as a liability) for determining balance-sheet insolvency.
- (11) The paid-in amount is classified as equity in accordance with the relevant accounting standards.
- (12) The instrument is directly issued and paid-in, and an Islamic Bank has not directly or indirectly funded the purchase of the instrument.
- (13) The paid-in amount is neither secured nor covered by a guarantee of an Islamic Bank or a related party, nor subject to any other arrangement that legally or economically enhances the seniority of the holder's claim in relation to the claims of an Islamic Bank's creditors.



- (14) The instrument is issued only with the approval of the owners of an Islamic Bank, either given directly by the owners or, if permitted by the applicable law, given by its Governing Body or by other persons authorised by the owners.
- (15) The instrument is clearly and separately disclosed on an Islamic Bank's balance sheet.

#### **Guidance**

This criterion is taken to be satisfied even if the instrument includes a permanent write-down mechanism.

#### **4.15. Additional Tier 1 Capital**

Additional Tier 1 Capital is the sum of the following elements:

- (a) instruments, issued by an Islamic Bank, that satisfy the criteria in rule 4.16 for inclusion in Additional Tier 1 Capital (and are not included in CET 1 Capital);
- (b) share premium (also known as stock surplus) resulting from the issue of instruments included in Additional Tier 1 Capital;
- (c) instruments, issued by consolidated subsidiaries of an Islamic Bank and held by third parties, that satisfy the criteria in rule 4.24 for inclusion in Additional Tier 1 Capital (and are not included in CET 1 Capital);
- (d) regulatory adjustments applied in the calculation of Additional Tier 1 Capital in accordance with Rules specified later in this chapter.

#### **4.16. Criteria for inclusion in Additional Tier 1 Capital**

- (1) An instrument issued by an Islamic Bank is included in Additional Tier 1 Capital if all of the criteria in parts (2) to (16) of this Rule are satisfied.
- (2) The instrument must be structured using unrestricted non-exchange-based contracts (such as *musharakah*) and must comply with other *Shari'ah* requirements.
- (3) The instrument is paid-in.
- (4) The instrument is the most subordinated claim after those of depositors, general creditors and holders of the subordinated debt of an Islamic Bank.
- (5) The paid-in amount is neither secured nor covered by a guarantee of an Islamic Bank or a related party, nor subject to any other arrangement that legally or economically enhances the seniority of the holder's claim in relation to the claims of an Islamic Bank's creditors.
- (6) The instrument is perpetual. It has no maturity date and there are no step-ups or other incentives to redeem.
- (7) If the instrument is callable by an Islamic Bank, it can only be called 5 years or more after the instrument is paid-in and only with the approval of the AFSA. An Islamic Bank must not do anything to create an expectation that the exercise of the option will be approved, and, if the exercise is approved, an Islamic Bank:
  - (a) must replace the called instrument with capital of the same or better quality and at conditions sustainable for the income capacity of an Islamic Bank; or



- (b) must demonstrate to the AFSA that its capital will significantly exceed an Islamic Bank's minimum Capital Requirement after the option is exercised.
- (8) A repayment of principal through repurchase, redemption or other means must be approved by the AFSA. An Islamic Bank must not assume, or create a market expectation, that such approval will be given.
- (9) The instrument must provide for an Islamic Bank to have, at all times, discretion not to make a distribution or pay a dividend. The exercise of the discretion must not impose restrictions on an Islamic Bank (except in relation to distributions to common shareholders) and must not constitute default.
- (10) Dividends and profits must be paid out of distributable items.
- (11) The instrument must not have a credit-sensitive-dividend feature under which a dividend or profit is periodically reset based (wholly or partly) on an Islamic Bank's credit standing.
- (12) The instrument must not contribute to an Islamic Bank's liabilities exceeding its assets if such a balance-sheet test forms part of any insolvency law applying in the jurisdiction where the instrument was issued.
- (13) An instrument classified as a liability for accounting purposes must have principal loss absorption through conversion to common shares, or a write-down mechanism that allocates losses to the instrument, at a pre-specified trigger point. The conversion must be made in accordance with Rule 4.20.
- (14) Neither an Islamic Bank nor a related party over which an Islamic Bank exercises control has purchased the instrument, nor has an Islamic Bank directly or indirectly funded the purchase of the instrument.
- (15) The instrument has no features that hinder re-capitalisation. For example, it must not require an Islamic Bank to compensate investors if a new instrument is issued at a lower price during a specified period.
- (16) If the instrument is not issued out of an operating entity (such as a special purpose vehicle (or SPV)) or the holding company in the group of which an Islamic Bank is a member, the proceeds are immediately available without limitation to an operating entity or the holding company through an instrument that satisfies the other criteria for inclusion in additional Tier 1 Capital.

#### **4.17. Tier 2 Capital**

Tier 2 Capital is the sum of the following elements:

- (a) instruments, issued by an Islamic Bank, that satisfy the criteria in rule 4.18 for inclusion in Tier 2 Capital (and are not included in Tier 1 Capital);
- (b) share premium (also known as stock surplus) resulting from the issue of instruments included in Tier 2 Capital;
- (c) instruments, issued by consolidated subsidiaries of an Islamic Bank and held by third parties, that satisfy the criteria in Rule 4.25 for inclusion in Tier 2 Capital (and are not included in Tier 1 Capital);
- (d) regulatory adjustments applied in the calculation of Tier 2 Capital in accordance with Rules specified later in this chapter;





- (e) general provisions or general reserves held against future, presently unidentified losses (but only up to a maximum of 1.25% of risk-weighted assets for Credit Risk, calculated using the standardised approach).

**Guidance**

- (1) General provisions and reserves are freely available to meet losses that subsequently materialise and therefore qualify for inclusion in Tier 2 Capital. In contrast, provisions for identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded because they would not be available to meet losses.
- (2) Even though they are called reserves, the PER and IRR are not part of Tier 2 Capital of an Islamic bank. They are part of the equity of PSIA investors and, as such, do not have the requisite loss absorbency.

**4.18. Criteria for inclusion in Tier 2 Capital**

- (1) An instrument issued by an Islamic Bank is included in Tier 2 Capital if all the criteria in sub-rules (2) to (11) are satisfied.
- (2) The instrument is paid-in.
- (3) The instrument is the most subordinated claim after those of depositors, general creditors and holders of the subordinated debt of an Islamic Bank.
- (4) The paid-in amount is neither secured nor covered by a guarantee of an Islamic Bank or a related party, nor subject to any other arrangement that legally or economically enhances the seniority of the holder's claim in relation to the claims of an Islamic Bank's depositors and general creditors.
- (5) The original maturity of the instrument is at least 5 years.
- (6) The recognition in Regulatory Capital in the remaining 5 years before maturity is amortised on a straight line basis and there are no step-ups or other incentives to redeem.
- (7) If the instrument is callable by an Islamic Bank, it can only be called 5 years or more after the instrument is paid-in and only with the approval of the AFSA. An Islamic Bank must not do anything to create an expectation that the exercise of the option will be approved, and, if the exercise is approved, an Islamic Bank:
  - (a) must replace the called instrument with capital of the same or better quality and at conditions sustainable for the income-generating capacity of an Islamic Bank; or
  - (b) must demonstrate to the AFSA that its capital will exceed an Islamic Bank's minimum Capital Requirement after the option is exercised.
- (8) The holder has no right to accelerate future scheduled payments of profit or principal, except in bankruptcy or liquidation.
- (9) The instrument does not have a credit-sensitive-dividend feature under which a dividend or profit is periodically reset based (wholly or partly) on an Islamic Bank's credit standing.
- (10) Neither an Islamic Bank nor a related party over which an Islamic Bank exercises control has purchased the instrument, nor has an Islamic Bank directly or indirectly funded the purchase of the instrument.





- (11) If the instrument is not issued out of an operating entity (such as an SPV) or the holding company in the group of which an Islamic Bank is a member, the proceeds are immediately available without limitation to an operating entity or the holding company through an instrument that satisfies the other criteria for inclusion in Tier 2 Capital.

#### 4.19. *Sukuk* as Tier 2 Capital

- (1) Subject to compliance with *Shari'ah*, an Islamic Bank may issue *sukuk* that qualifies for inclusion in Tier 2 Capital under rule 4.20. For the *sukuk*, the underlying assets are convertible to common equity at the point of non-viability.
- (2) The *sukuk* contract must state the terms of conversion, trigger point and conversion ratio. The conversion must be made in accordance with Rule 4.20.

#### 4.20. Requirements—loss absorption at point of non-viability

- (1) This rule applies to an Additional Tier 1 or Tier 2 instrument issued by an Islamic bank. It sets out additional requirements to ensure loss absorption at the point of non-viability.
- (2) The terms and conditions of an instrument must give the AFSA the discretion to direct that the instrument be written-off or converted to common equity on the occurrence of a trigger event.
- (3) An Islamic Bank must be able to issue the required number of shares specified in the instrument if a trigger event happens. The issuance of any new shares because of a trigger event must happen before any public sector injection of capital so that capital provided by the public sector is not diluted.
- (4) Trigger event, in relation to an Islamic Bank that issued the instrument, is the earliest of:
  - (a) a decision of the AFSA that a write-off (without which an Islamic Bank would become non-viable) is necessary; and
  - (b) a decision by the relevant authority in AIFC to make a public sector injection of capital, or give equivalent support (without which injection or support an Islamic Bank would become non-viable, as determined by that authority).
- (5) If an Islamic Bank is a member of a Financial Group and an Islamic Bank wishes the instrument to be included in the Group's capital in addition to its solo capital, the trigger event must be the earliest of:
  - (c) the decision in part (4) (a) of this Rule 4.20;
  - (d) the decision in part (4) (b) of this Rule 4.20;
  - (e) a decision, by the relevant authority in the parent's home jurisdiction, that a write-off (without which an Islamic Bank would become non-viable) is necessary; or
  - (f) a decision, by the relevant authority in the jurisdiction of the financial regulator that regulates any parent of the Islamic Bank, to make a public sector injection of capital, or give equivalent support, in that jurisdiction (without which injection or support an Islamic Bank would become non-viable, as determined by that authority).
- (6) Any compensation paid to the holder of an instrument because of a write-off must be paid immediately in the form of common shares (or the equivalent for non-joint-stock companies).



- (7) If an Islamic Bank is a member of a Financial Group, any common shares paid as compensation to the holder of the instrument must be common shares of an Islamic Bank or of the parent entity of the group.

#### Guidance

Conversion or write-off under this rule would be limited to the extent necessary to enable the AFSA to conclude that an Islamic Bank is viable without further conversion or write-off.

#### 4.21. Requirements for writing-off

- (1) For an instrument that is to be written-off under Rule 4.20:
- (a) the write-off must reduce:
    - (i) the claim of the instrument in liquidation;
    - (ii) the amount repaid when a call option is exercised; and
    - (iii) dividend or profit payments on the instrument;
  - (b) the write-off must be permanent;
  - (c) the provisions governing the issuance of the instrument must specify that a write-off does not constitute default or trigger cross-default clauses; and
  - (d) the write-off must generate CET 1 Capital under the relevant accounting standards and the instrument will only receive recognition in Tier 2 Capital up to the minimum level of CET 1 Capital generated by a full write-off of the instrument.
- (2) The write-off of an instrument using a *murabahah* contract must be through the investor (as creditor):
- (a) making a promise (*wa'ad*) to waive rights on debts at the point of non-viability; or
  - (b) agreeing, in the relevant legal documents, to waive rights on debts at the point of non-viability.
- (3) The write-off of an instrument using an *ijarah* contract must be through the investor (as lessor):
- (a) making a promise (*wa'ad*) to transfer ownership of the underlying asset (beneficial or otherwise) to the lessee without consideration; or
  - (b) agreeing, in the relevant legal documents, to waive rights on accrued rental at the point of non-viability.
- (4) An Islamic Bank may apply to the AFSA for approval to use a write-off mechanism other than those in sub-rules (2) and (3) above.

#### 4.22. Inclusion of third parties' interests

This Section of Chapter 4 sets out the criteria and formulae for the inclusion, in an Islamic bank's Regulatory Capital, of interests held by third parties.



**4.23. Criteria for third party interests—Common Equity Tier 1 Capital**

- (1) For Rule 4.13, a common share, issued by a consolidated Subsidiary of an Islamic Bank and held by a third party as a non-controlling interest, may be included in the Islamic Bank's CET 1 Capital if:
  - (a) the share would be included in the Islamic Bank's CET 1 Capital had it been issued by the Islamic Bank itself; and
  - (b) the Subsidiary that issued the share is itself an Islamic bank or Islamic Broker Dealer (or an equivalent entity in its home jurisdiction).
- (2) The amount to be included in the consolidated CET 1 Capital of an Islamic Bank is calculated in accordance with the following formula:

$$NCI - ((CET1_s - Min) \times SS)$$

where:

**NCI** is the total of the non-controlling interests of third parties in a consolidated Subsidiary of an Islamic Bank.

**CET1<sub>s</sub>** is the amount of CET 1 Capital of the subsidiary.

**Min** is the lower of:

- (a) 7% × (minimum CET 1 Capital requirement of the subsidiary); and
- (b) 7% × (the part of the consolidated minimum CET 1 Capital requirement that relates to the subsidiary).

**SS** means the percentage of the shares in the Subsidiary (being shares included in CET 1 Capital) held by those third parties.

**4.24. Criteria for third party interests—Additional Tier 1 Capital**

- (1) For Rule 4.15 (c ), an instrument (including a common share) issued by a consolidated Subsidiary of an Islamic Bank and held by a third party as a non-controlling interest may be included in an Islamic Bank's additional Tier 1 Capital if the instrument would be included in an Islamic Bank's additional Tier 1 Capital had it been issued by an Islamic Bank.
- (2) Any amount already included in CET 1 Capital must not be included in Additional Tier 1 Capital.
- (3) The amount to be included in the consolidated Additional Tier 1 Capital of an Islamic Bank is calculated in accordance with the following formula:

$$NCI - ((T1_s - Min) \times SS)$$

where:

**NCI** is the total of the non-controlling interests of third parties in a consolidated Subsidiary of an Islamic Bank.

**T1<sub>s</sub>** is the amount of Additional Tier 1 Capital of the subsidiary.



**Min** is the lower of:

- (a)  $8.5\% \times$  (minimum Additional Tier 1 Capital requirement of the subsidiary); and
- (b)  $8.5\% \times$  (the part of the consolidated minimum Additional Tier 1 Capital requirement that relates to the subsidiary).

**SS** means the percentage of the shares in the Subsidiary (being shares included in Additional Tier 1 Capital) held by those third parties.

#### 4.25. Criteria for third party interests—Tier 2 Capital

- (1) For rule 4.17 (c), an instrument (including a common share and any other Tier 1 Capital instrument) issued by a consolidated Subsidiary of an Islamic Bank and held by a third party as a non-controlling interest may be included in the Islamic Bank's Tier 2 Capital if the instrument would be included in the Islamic Bank's Tier 2 Capital had it been issued by the Islamic Bank.
- (2) Any amount already included in CET 1 Capital or Additional Tier 1 Capital must not be included in Tier 2 Capital.
- (3) The amount to be included in the consolidated Tier 2 Capital of an Islamic Bank is calculated in accordance with the following formula:

$$NCI - ((T2_s - Min) \times SS)$$

where:

**NCI** is the total of the non-controlling interests of third parties in a consolidated Subsidiary of an Islamic Bank.

**T2s** is the amount of Tier 2 Capital of the subsidiary.

**Min** is the lower of:

- (a)  $10.5\% \times$  (minimum Tier 2 Capital requirement of the subsidiary); and
- (b)  $10.5\% \times$  (the part of the consolidated minimum Tier 2 Capital requirement that relates to the subsidiary).

**SS** means the percentage of the shares in the Subsidiary (being shares included in Tier 2 Capital) held by those third parties.

#### 4.26. Treatment of third party interests from SPVs

- (1) An instrument issued out of an SPV and held by a third party must not be included in an Islamic Bank's CET 1 Capital. Such an instrument may be included in an Islamic Bank's Additional Tier 1 or Tier 2 Capital (and treated as if it had been issued by an Islamic Bank itself directly to the third party) if:
  - (a) the instrument satisfies the criteria for inclusion in the relevant category of Regulatory Capital; and
  - (b) the only asset of the SPV is its investment in the capital of an Islamic Bank and that investment satisfies the criterion in rule 4.16 or 4.18 for the immediate availability of the proceeds.



- (2) An instrument described in part (1) of this Rule that is issued out of a SPV through a consolidated Subsidiary of an Islamic Bank may be included in an Islamic Bank's consolidated Additional Tier 1 or Tier 2 Capital if the instrument satisfies the criteria in rule 4.16 or 4.18, as the case requires. Such an instrument is treated as if it had been issued by the Subsidiary itself directly to the third party.

#### **4.27. Regulatory adjustments**

- (1) Regulatory adjustments to an Islamic bank's capital may be required to avoid double-counting, or artificial inflation, of its capital. They may also be required in relation to assets that cannot readily be converted into cash.
- (2) Adjustments can be made to all 3 categories of Regulatory Capital, but most of them are to CET 1 Capital.

#### **4.28. Approaches to valuation and adjustment**

- (1) An Islamic Bank must use the same approach for valuing regulatory adjustments to its capital as it does for balance-sheet valuations. An item that is deducted from capital must be valued in the same way as it would be for inclusion in an Islamic Bank's balance sheet.
- (2) An Islamic Bank must use the corresponding deduction approach and the threshold deduction rule in making adjustments to its capital.

#### **4.29. Definitions**

Entity concerned means:

- (a) a financial entity (including an Islamic Bank and a takaful entity); or
- (b) any other entity over which, under the relevant accounting standards, an Islamic Bank can exercise control.

Significant investment, by an Islamic Bank in an entity concerned, means an investment of 10% or more in the common shares, or other instruments that qualify as capital, of the entity concerned. Investment includes a direct, indirect and synthetic holding of capital instruments.

#### **Guidance**

- (1) The notion of exercising control in this chapter is different from that in the definition of exercise control in the glossary. The term as defined in the glossary is used in relation to related parties and connected parties as they relate to Credit Risk, concentration risk and large exposures.
- (2) The relevant accounting standards referred to (primarily AAOIFI and IFRS) use control in a much broader sense, so that an investor should consider all relevant facts and circumstances in assessing whether it controls an investee.
- (3) Under IFRS 10, for example, an investor controls an investee if the investor has all of the following:
  - (i) power over the investee (that is, the investor has existing rights that give it the ability to direct the activities that significantly affect the investee's returns)
  - (ii) exposure, or rights, to variable returns from its involvement with the investee



- (iii) ability to use its power over the investee to affect the amount of the investor's returns.
- (4) Another example would be control through agreement with the entity's other shareholders or with the entity itself. The agreement could result in control even if the investor holds less than majority voting rights, so long as those rights are substantive (that is, exercisable by the investor who has the practical ability to exercise them when relevant decisions are required to be made).

#### **4.30. Adjustments to Common Equity Tier 1 Capital**

Adjustments to CET 1 Capital must be made in accordance with the Rules specified in the following Rules 4.31 to 4.45. Regulatory adjustments are generally in the form of deductions, but they may also be in the form of recognition or de-recognition of items in the calculation of an Islamic Bank's capital.

#### **4.31. Goodwill and intangible assets**

An Islamic Bank must deduct from CET 1 Capital the amount of its goodwill and other intangible assets (except real estate financing servicing rights). The amount must be net of any related deferred tax liability that would be extinguished if the goodwill or assets become impaired or derecognised under the relevant accounting standards.

#### **4.32. Deferred tax assets**

- (1) An Islamic Bank must deduct from CET 1 Capital the amount of deferred tax assets (except those that relate to temporary differences) that depend on the future profitability of an Islamic Bank.
- (2) A deferred tax asset may be netted with a deferred tax liability only if the asset and liability relate to taxes levied by the same taxation authority and offsetting is explicitly permitted by that authority. A deferred tax liability must not be used for netting if it has already been netted against a deduction of goodwill, other intangible assets or defined benefit pension assets.

#### **Guidance**

Any deferred tax liability that may be netted must be allocated pro rata between deferred tax assets under this rule and those under the threshold deduction rule. For the treatment of deferred tax assets that relate to temporary differences (for example, allowance for financing losses).

#### **4.33. Cash flow hedge reserve**

In the calculation of CET 1 Capital, an Islamic Bank must derecognise the amount of the cash flow hedge reserve that relates to the hedging of items that are not fair-valued on the balance sheet (including projected cash flows).

#### **4.34. Cumulative gains and losses from changes to own Credit Risk**

In the calculation of CET 1 Capital, an Islamic Bank must derecognise all unrealised gains and unrealised losses that have resulted from changes in the fair value of liabilities that are due to changes in an Islamic Bank's own Credit Risk.



**4.35. Defined benefit pension fund assets**

- (1) An Islamic Bank must deduct from CET 1 Capital the amount of a defined benefit pension fund that is an asset on an Islamic Bank's balance sheet. The amount must be net of any related deferred tax liability that would be extinguished if the asset becomes impaired or derecognised under the relevant accounting standards.
- (2) An Islamic Bank may apply to the AFSA for approval to offset from the deduction any asset in the defined benefit pension fund to which an Islamic Bank has unrestricted and unfettered access. Such an asset must be assigned the risk-weight that would be assigned if it were owned directly by an Islamic Bank.

**4.36. Securitisation gains on sale**

In the calculation of CET 1 Capital, an Islamic Bank must derecognise any increase in Equity Capital or CET 1 Capital from a securitisation or re-securitisation transaction (for example, an increase associated with expected future margin income resulting in a gain-on-sale).

**4.37. Assets lodged or pledged to secure liabilities**

- (1) An Islamic Bank must deduct from CET 1 Capital the amount of any assets lodged or pledged by it, if:
  - (a) the assets were lodged or pledged to secure liabilities incurred by the Islamic Bank; and
  - (b) the assets are not available to meet the liabilities of the Islamic Bank.
- (2) The AFSA may determine that, in the circumstances, the amount of assets lodged or pledged need not be deducted from an Islamic Bank's CET 1 Capital.

**4.38. Acknowledgments of debt**

- (1) An Islamic Bank must deduct from CET 1 Capital the net present value of an acknowledgement of debt outstanding issued by it to directly or indirectly fund instruments that qualify as CET 1 Capital.
- (2) This rule does not apply if the acknowledgement is subordinated in rank similar to that of instruments that qualify as CET 1 Capital.

**4.39. Accumulated losses**

An Islamic Bank must deduct from its CET 1 Capital the amount of any accumulated losses.

**4.40. Deductions from categories of Regulatory Capital**

- (1) The deductions that must be made from CET 1 Capital, Additional Tier 1 Capital or Tier 2 Capital under the corresponding deduction approach are set out in this section of IBB Module. An Islamic Bank must examine its holdings of index securities and any underlying holdings of capital to determine whether any deductions are required as a result of such indirect holdings.
- (2) Deductions must be made from the same category for which the capital would qualify if it were issued by the Islamic Bank itself or, if there is not enough capital at that category, from the next higher category.





- (3) The corresponding deduction approach applies regardless of whether the positions or exposures are held in the Banking Book or Trading Book.
- (4) If the amount of Tier 2 Capital is insufficient to cover the amount of deductions from that category, the shortfall must be deducted from additional Tier 1 Capital and, if additional Tier 1 Capital is still insufficient, the remaining amount must be deducted from CET 1 Capital.

**4.41. Investments in own shares and Capital instruments**

- (1) An Islamic Bank must deduct direct or indirect investments in its own common shares or own capital instruments (except those that have been derecognised under the relevant accounting standards). The Islamic Bank must also deduct any of its own common shares or instruments that it is contractually obliged to purchase.
- (2) The gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk. However, gross long positions in its own shares resulting from holdings of index securities may be netted against short positions in its own shares resulting from short positions in the same underlying index, even if those short positions involve counterparty risk.

**4.42. Reciprocal cross holdings**

An Islamic Bank must deduct reciprocal cross holdings in shares, or other instruments that qualify as capital, of an entity concerned.

**4.43. Non-significant investments—aggregate is less than 10% of firm's Common Equity Tier 1 Capital**

- (1) This rule applies if:
  - (a) an Islamic Bank makes a non-significant investment in an entity concerned;
  - (b) the entity concerned is an unconsolidated entity (that is, the entity is not included in an Islamic Bank's consolidated returns);
  - (c) an Islamic Bank does not own 10% or more of the common shares of the entity concerned; and
  - (d) after applying all other regulatory adjustments, the total of the deductions required to be made under this rule is less than 10% of an Islamic Bank's CET 1 Capital.
- (2) An Islamic Bank must deduct any investments in common shares, or other instruments that qualify as capital, of an entity concerned.
- (3) The amount to be deducted is the net long position (that is, the gross long position net of short positions in the same underlying exposure if the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least 1 year).
- (4) Underwriting positions held for more than 5 business days must also be deducted.
- (5) If a capital instrument is required to be deducted and it is not possible to determine whether it should be deducted from CET 1 Capital, Additional Tier 1 Capital or Tier 2 Capital, the deduction must be made from CET 1 Capital.





**4.44. Non-significant investments—aggregate is 10% or more of firm’s Common Equity Tier 1 Capital**

- (1) This rule applies if, after applying all other regulatory adjustments, the total of the deductions required to be made under rule 4.43 is 10% or more of an Islamic Bank’s CET 1 Capital.
- (2) An Islamic Bank must deduct the amount by which the total of the deductions required to be made under rule 4.43 exceeds 10% of an Islamic Bank’s CET 1 Capital. This amount to be deducted is referred to as the excess.
- (3) The excess to be deducted from each category of Regulatory Capital under the corresponding deduction approach is calculated in accordance with the following formula:

$$Excess \times \frac{A}{B}$$

where:

A is the amount of CET 1 Capital, additional Tier 1 Capital or Tier 2 Capital of the Islamic bank, as the case requires.

B is the total capital holdings of the Islamic Bank.

**4.45. Significant investments**

- (1) This rule applies if:
  - (a) an Islamic Bank makes a significant investment in an entity concerned;
  - (b) the entity concerned is an unconsolidated entity (that is, the entity is not included in an Islamic Bank’s consolidated returns); and
  - (c) an Islamic Bank owns 10% or more of the common shares of the entity concerned.
- (2) An Islamic Bank must deduct the total amount of investments in the entity concerned (other than investments in common shares, or other instruments that qualify as CET 1 Capital, of the entity).
- (3) For the treatment of investments in common shares, or other instruments that qualify as CET 1 Capital, of an entity concerned, see Rule 4.46 (Deductions from Common Equity Tier 1 Capital).
- (4) The amount to be deducted is the net long position (that is, the gross long position net of short positions in the same underlying exposure if the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least 1 year).
- (5) Underwriting positions held for more than 5 business days must also be deducted.
- (6) If a capital instrument is required to be deducted and it is not possible to determine whether it should be deducted from CET 1 Capital, Additional Tier 1 Capital or Tier 2 Capital, the deduction must be made from CET 1 Capital.



**4.46. Deductions from Common Equity Tier 1 Capital**

- (1) In addition to the other deductions to CET 1 Capital under this Chapter, deductions may be required to CET 1 Capital under the threshold deduction rule.
- (2) The threshold deduction rule provides recognition for particular assets that are considered to have some limited capacity to absorb losses. The following items come within the threshold deduction rule:
  - (a) significant investments in the common shares, or other instruments that qualify as CET 1 Capital, of an unconsolidated entity concerned;
  - (b) real estate financing servicing rights;
  - (c) deferred tax assets that relate to temporary differences (for example, allowance for credit losses).
- (3) Instead of full deduction, the items that come within the threshold deduction rule receive limited recognition when calculating CET 1 Capital. The total of each of the items in (2) above, do not require adjustment from CET 1 Capital and are risk-weighted at 300% (for items listed on a recognised exchange) or 400% (for items not so listed) provided that:
  - (a) each item is no more than 10% of an Islamic Bank's CET 1 Capital (net of all regulatory adjustments except those under this section); or
  - (b) in total, the 3 items are no more than 15% of an Islamic Bank's CET 1 Capital (net of all regulatory adjustments except those under this Subdivision).
  - (c) An Islamic Bank must deduct from CET 1 Capital any amount in excess of the threshold in (3) (a) or (b).



## 5. CAPITAL BUFFERS AND OTHER REQUIREMENTS

### 5.1. Introduction

- (1) The Basel III capital adequacy framework contains 2 additional measures for conserving capital through the Capital Conservation Buffer and the Counter-Cyclical Capital Buffer.
- (2) The Capital Conservation Buffer promotes the conservation of capital and the build-up of a buffer above the minimum in times of economic growth and credit expansion leading to profitability, so that the buffer can be drawn down in periods of stress. It imposes an obligation to restrict a firm's distributions when capital falls below the Capital Conservation Buffer minimum.
- (3) The rules requirements relating to application of Capital Conservation Buffer are set out in this Chapter.

### 5.2. Capital Conservation Buffer

- (1) An Islamic Bank whose Risk-based Capital Requirement is higher than its Base Capital Requirement must maintain a minimum Capital Conservation Buffer of:
  - (a) 2.5% of its total RWA; or
  - (b) a higher amount that the AFSA may, by written notice, set from time to time.
- (2) A firm's Capital Conservation Buffer must be made up of CET 1 Capital above the amounts used to meet an Islamic Bank's CET 1 Capital ratio, Tier 1 Capital ratio and Regulatory Capital ratio in rule 4.11).
- (3) Capital raised through the issuance of *sukuk* cannot form part of the Capital Conservation Buffer because that capital does not qualify as CET 1 Capital.

### 5.3. Capital Conservation Ratio

- (1) If an Islamic bank's Capital Conservation Buffer falls below the required minimum, the Islamic Bank must immediately conserve its capital by restricting its distributions.
- (2) This rule sets out, in column 3 of table 5.1, the minimum Capital Conservation Ratios for Islamic bank that are required to maintain a Capital Conservation Buffer. Capital Conservation ratio is the percentage of earnings that a firm must not distribute if its CET 1 Capital ratio falls within the corresponding ratio in column 2 of that table.
- (3) Earnings means distributable profits calculated before deducting elements subject to the restrictions on distributions. Earnings must be calculated after notionally deducting the tax that would have been payable had none of the distributable items been paid.
- (4) If the Islamic Bank is a member of a Financial Group, the Capital Conservation Buffer applies at group level.
- (5) A payment made by a firm that does not reduce its CET 1 Capital is not a distribution for the purposes of this Chapter. Distributions include, for example, dividends, share buybacks and discretionary bonus payments.
- (6) The effect of calculating earnings after tax is that the tax consequence of the distribution is reversed out.



- (7) An Islamic Bank must have adequate systems and controls to ensure that the amount of distributable profits and maximum distributable amount are calculated accurately. An Islamic Bank must be able to demonstrate that accuracy if directed by the AFSA.

**Guidance: Examples of application of table**

Assume that a firm's minimum CET 1 Capital ratio is 4.5% and an additional 2.5% Capital Conservation Buffer (which must be made up of CET 1 Capital) is required for a total of 7% CET 1 Capital ratio. Based on table 5.1:

- (i) If a firm's CET 1 Capital ratio is 4.5% or more but less than 5.125%, an Islamic Bank needs to conserve 100% of its earnings.
- (ii) If a firm's CET 1 Capital ratio is 5.125% or more but less than 5.75%, an Islamic Bank needs to conserve 80% of its earnings and must not distribute more than 20% of those earnings by way of dividends, share buybacks and discretionary bonus payments.
- (iii) A firm with a CET 1 Capital ratio of more than 7% can distribute 100% of its earnings.

**Table 5.1 Minimum Capital conservation ratios**

item	CET 1 Capital ratio	Minimum Capital conservation ratio (% of earnings)
1	4.5% to 5.125%	100
2	≥5.125% to 5.75%	80
3	≥5.75% to 6.375%	60
4	≥6.375% to 7.0%	40
5	≥7%	0

**5.4. Powers of the AFSA**

- (1) The AFSA may impose a restriction on capital distributions by an Islamic Bank even if the amount of an Islamic Bank's CET 1 Capital is greater than its CET 1 Capital ratio and required Capital Conservation Buffer.
- (2) The AFSA may, by written notice, impose a limit on the period during which an Islamic Bank may operate within a specified Capital Conservation Ratio.
- (3) An Islamic Bank may apply to the AFSA to make a distribution in excess of a limit imposed by this Chapter. The AFSA will grant approval only if it is satisfied that an Islamic Bank has appropriate measures to raise capital equal to, or greater than, the amount an Islamic Bank wishes to distribute above the limit.

**5.5. Capital reductions**

- (1) An Islamic Bank must not reduce its capital and reserves without the AFSA's written approval.



- (2) An Islamic Bank planning a reduction must prepare a forecast (for at least 2 years) showing its projected capital after the reduction. The Islamic Bank must satisfy the AFSA that its capital will still comply with the IBB Module after the reduction.

**Guidance: Examples of ways to reduce Capital**

- 1) a share buyback or the redemption, repurchase or repayment of capital instruments issued by an Islamic Bank
- 2) trading in an Islamic Bank's own shares or capital instruments outside an arrangement agreed with the AFSA.
- 3) a special dividend.

**5.6. AFSA can require other matters**

Despite anything in these rules, the AFSA may require an Islamic Bank to have capital resources, comply with any other capital requirement or use a different approach to, or method for, capital management. The AFSA may also require a firm to carry out stress-testing at any time.

**5.7. Leverage Ratio**

- (1) The rule requirements relating to Leverage ratio specified in Rule 5.7 apply only to Islamic Banks excluding entities licensed to Providing Islamic Financing and Dealing in Investments as principal in a *Shari'ah*-compliant manner.
- (2) An Islamic Bank must calculate its Leverage Ratio in accordance with the following formula:

$$\text{Leverage ratio} = \frac{\text{Capital Measure}}{\text{Exposure Measure}}$$

Where:

- (a) "Capital measure" represents T1 Capital of the Islamic Bank calculated in accordance with Rule 4.12; and
  - (b) "Exposure measure" represents the value of exposures of the Islamic Bank calculated in accordance with sub-rules (3) to (6) of this rule.
- (3) The Exposure Measure referred in Rule 5.7 (2) (b) must be calculated as the sum of:
- (a) on-balance sheet items; and
  - (b) off-balance sheet items.
- (4) In relation to on-balance sheet items:
- (a) for securities financing transactions, the exposure value must be calculated in accordance with IFRS and the netting requirements referred in Rules on Credit Risk Mitigation (CRM) in Chapter 6 of IBB Module;
  - (b) for Derivatives, including financing protection sold, the exposure value must be



calculated as the sum of the on-balance sheet value in accordance with IFRS and an add-on for potential future exposure calculated in accordance with Rules on Credit Risk Mitigation in Chapter 6 of IBB Module; and

- (c) for other on-balance sheet items, the exposure value must be calculated based on their balance sheet values in accordance with Rules in Chapter 6 of IBB Module.
- (5) In relation to off-balance sheet items:
- (a) for commitments that are unconditionally cancellable at any time by the Islamic Bank without prior notice, the exposure value should be the notional amount for the item multiplied by a Credit Conversion Factor of 10%; and
  - (b) for other off-balance sheet items, including:
    - (i) direct financing substitutes;
    - (ii) certain transaction-related contingent items;
    - (iii) short-term self-liquidating trade-related contingent items and commitments to underwrite debt and equity securities;
    - (iv) note issuance facilities and revolving underwriting facilities;
    - (v) transactions, other than SFTs, involving the posting of securities held by the Islamic Bank as collateral;
    - (vi) asset sales with recourse, where the financing risk remains with the Islamic Bank;
    - (vii) other commitments with certain drawdown;
    - (viii) any other commitments; and
    - (ix) unsettled transactions.

the exposure value must be calculated as the notional amount for each of the items multiplied by a Credit Conversion Factor of 100%.

- (6) For the purpose of determining the Exposure Measure, the value of exposures of an Islamic Bank must be calculated in accordance with the International Financial Reporting Standards (IFRS) subject to the following adjustments:
- (a) on-balance sheet, non-derivative exposures must be net of specific allowances and valuation adjustments (e.g. financing valuation adjustments);
  - (b) physical or financial collateral, guarantees or Credit Risk Mitigation purchased must not be used to reduce on-balance sheet exposures; and
  - (c) financings or other exposures must not be netted with PSIA/deposits or investments made collateralizing them.



## 6. CREDIT RISK

### 6.1. General

- (1) This Chapter sets out the requirements for an Islamic bank's Credit Risk management policy (including Credit Risk assessments and the use of ratings from ECRAs):
  - (a) to implement the risk-based framework for capital adequacy; and
  - (b) to ensure the early identification and management of problem assets.
- (2) This Chapter also deals with the following means to determine Regulatory Capital and control or mitigate Credit Risk:
  - (a) the Risk-Weighted Assets approach;
  - (b) CRM techniques;
  - (c) provisioning.
- (3) To guard against abuses and to address conflicts of interest, this Chapter requires transactions with related parties to be at arm's length.

### 6.2. Credit Risk

**Credit Risk** is:

- (a) the risk of default by counterparties; and
- (b) the risk that an asset will lose value because its credit quality has deteriorated.

#### Guidance

Credit Risk may result from on-balance-sheet and off-balance-sheet exposures, including financing and advances, investments, inter-bank financing, securities financing transactions and trading activities. It can exist in a firm's Trading Book or Banking Book.

#### Examples of sources of Credit Risks in Islamic Bank

- (i) accounts receivable in *murabahah* contracts;
- (ii) counterparty risk in *salam* contracts;
- (iii) accounts receivable and counterparty risk in *istisna* contracts;
- (iv) lease payments receivable in *ijarah* contracts;
- (v) *sukuk* held in the Banking Book;
- (vi) capital impairment from investments, based on *mudarabah* or *musharakah* contracts, held in the Banking Book.



**6.3. Requirements—management of Credit Risk and problem assets**

- (1) An Islamic Bank must manage Credit Risk by adopting a prudent Credit Risk management policy that allows its Credit Risk to be identified, measured, evaluated, managed and controlled or mitigated.
- (2) The policy must also provide for problem assets to be recognised, measured and reported. The policy must set out the factors that must be taken into account in identifying problem assets.
- (3) Problem asset includes impaired credit and other assets if there is reason to believe that the amounts due may not be collectable in full or in accordance with their terms.

**6.4. Role of Governing Body—Credit Risk**

An Islamic bank's Governing Body must ensure that the Islamic Bank's Credit Risk management policy gives an Islamic Bank a comprehensive bank-wide view of its Credit Risk and covers the full credit lifecycle (including credit underwriting, credit evaluation, and the management of the Islamic bank).

**6.5. Credit Risk management policy**

- (1) An Islamic Bank must establish and implement a Credit Risk management policy:
  - (a) that is appropriate for the nature, scale and complexity of its business and for its risk profile; and
  - (b) that enables an Islamic Bank to identify, measure, evaluate, manage and control or mitigate Credit Risk.
  - (c) The objective of the policy is to give an Islamic Bank the capacity to absorb any existing and estimated future losses arising from Credit Risk.

**6.6. Policies—general Credit Risk environment**

An Islamic bank's Credit Risk management policy must include:

- (a) a well-documented and effectively-implemented process for assuming Credit Risk that does not rely unduly on external credit ratings;
- (b) well-defined criteria for approving credit (including prudent underwriting standards), and renewing, refinancing and restructuring existing credit;
- (c) a process for identifying the approving AFSA for credit, given its size and complexity;
- (d) effective Credit Risk administration, including:
  - (i) periodic analysis of counterparties' ability and willingness to repay; and
  - (ii) monitoring of documents, legal covenants, contractual requirements, and collateral and other CRM techniques;





- (e) effective systems for the accurate and timely identification, measurement, evaluation, management and control or mitigation of Credit Risk, and reporting to an Islamic Bank's Governing Body and senior management;
- (f) procedures for tracking and reporting exceptions to, and deviations from, credit limits or policies;
- (g) prudent and appropriate credit limits that are consistent with an Islamic Bank's risk tolerance, risk profile and Capital; and
- (h) effective controls for the quality, reliability and relevance of data and validation procedures.

### Guidance

Depending on the nature, scale and complexity of an Islamic bank's Credit Risk, and how often it provides credit or incurs Credit Risk, its Credit Risk management policy should include:

- (1) how an Islamic Bank defines and measures Credit Risk;
- (2) an Islamic Bank's business aims in incurring Credit Risk, including:
  - (a) identifying the types and sources of Credit Risk that an Islamic Bank will permit itself to be exposed to (and the limits on that exposure) and those that it will not
  - (b) setting out the degree of diversification that an Islamic Bank requires, an Islamic Bank's tolerance for risk concentrations and the limits on exposures and concentrations
  - (c) stating the risk-return trade-off that an Islamic Bank is seeking to achieve;
- (3) the kinds of credit to be offered, and ceilings, pricing, profitability, maximum maturities and ratios for each kind of credit;
- (4) a ceiling for the total credit portfolio (in terms, for example, of financing-to-deposit ratio, undrawn commitment ratio, maximum amount or percentage of an Islamic Bank's Capital);
- (5) portfolio limits for maximum gross exposures by region or country, by industry or sector, by category of counterparty (such as banks, non-bank financial entities and corporate counterparties), by product, by counterparty and by connected counterparties;
- (6) limits, terms and conditions, approval and review procedures and records kept for financing to connected counterparties;
- (7) types of collateral, financing-to-value ratios and criteria for accepting guarantees;
- (8) the detailed limits for Credit Risk, and a Credit Risk structure, that:
  - (a) takes into account all significant risk factors, including intra-group exposures
  - (b) is commensurate with the scale and complexity of an Islamic Bank's activities
  - (c) is consistent with an Islamic Bank's business aims, historical performance, and the amount of capital it is willing to risk;



- (9) procedures for:
  - (a) approving new products and activities that give rise to Credit Risk
  - (b) regular risk position and performance reporting;
  - (c) approving and reporting exceptions to limits;
- (10) allocating responsibilities for implementing the Credit Risk management policy and monitoring adherence to, and the effectiveness of, the policy; and
- (11) the required information systems, staff and other resources.

#### **6.7. Credit Risk Management Policy**

- (1) An Islamic bank's Credit Risk management policy must require that financing decisions are free of conflicts of interest and are made on an arm's-length basis. In particular, the financing approval and review functions must be independent of the financing initiation function.
- (2) An Islamic bank's Credit Risk management policy must provide for monitoring the total indebtedness of each counterparty and any risk factors that might result in default (including any significant unhedged foreign exchange risk).
- (3) The policy must include stress-testing an Islamic Bank's financing exposures at intervals appropriate for the nature, scale and complexity of an Islamic Bank's business and for its risk profile. It must also include a yearly review of stress scenarios, and procedures to make any necessary changes arising from the review.
- (4) The policy must state that decisions relating to the following are made at the appropriate level of the Islamic Bank's senior management or Governing Body:
  - (a) exposures exceeding a stated amount or percentage of an Islamic Bank's capital;
  - (b) exposures that, in accordance with criteria set out in the policy, are especially risky;
  - (c) exposures that are outside an Islamic Bank's core business.
- (5) An Islamic Bank must give the AFSA full access to information in its financing portfolio, including access to staff involved in assuming, managing and reporting on Credit Risk.

#### **Guidance**

- (1) This rule excludes arrangements such as an employee financing scheme, so long as the policy ensures that the scheme's terms, conditions and limits are generally available to employees and adequately addresses the risks and conflicts that arise from financing under it.
- (2) The Credit Risk management policy of an Islamic Bank should clearly set out who has the authority to approve financing to employees.
- (3) The authority of a credit committee or credit officer should be appropriate for the products or portfolio and should be commensurate with the committee's or officer's credit experience and expertise.



- (4) Each approving authority should be reviewed regularly to ensure that it remains appropriate for current market conditions and the committee's or officer's performance.
- (5) An Islamic bank's remuneration policy should be consistent with its Credit Risk management policy and should not encourage officers to attempt to generate short-term profits by taking an unacceptably high level of risk.
- (6) The level at which financing decisions are made should vary depending on the kind and amount of credit and the nature, scale and complexity of an Islamic Bank's business. For some firms, a credit committee with formal terms of reference might be appropriate; for others, individuals with pre-assigned limits would do.
- (7) An Islamic Bank should ensure, through periodic independent audits, which the financing approval function is properly managed and that financing exposures comply with prudential standards and internal limits. The results of audits should be reported directly to the Governing Body, credit committee or senior management, as appropriate.

### 6.8. Credit Risk assessment

#### Guidance

- i) This section of IBB Module sets out a standardised approach for Credit Risk assessment, and requires an Islamic Bank to establish and implement policies to identify, measure, evaluate, manage and control or mitigate Credit Risk and to calculate its Credit Risk Capital Requirement.
- ii) Credit Risk assessment under this Chapter is different from the evaluation (often called credit assessment) made by a firm as part of its financing approval process.
- iii) Credit assessment is part of an Islamic Bank's internal commercial decision-making for approving or refusing credit; it consists of the evaluation of a prospective counterparty's repayment ability. In contrast, Credit Risk assessment is done by an Islamic Bank (using ratings and risk-weights set out in these rules) as part of calculating its Credit Risk Capital Requirement.
- iv) An Islamic Bank involved in financing syndications or consortia should not rely on other parties' assessments of the Credit Risk involved and should carry out a full assessment based on its own Credit Risk management policy.

An Islamic Bank must establish and implement appropriate policies to enable it to assess Credit Risk when the credit is granted or the risk is incurred, and afterwards. In particular, the policies must enable an Islamic Bank:

- (a) to measure Credit Risk (including the Credit Risk of off-balance-sheet items in credit equivalent terms);
- (b) to effectively use its internal Credit Risk assessment;
- (c) to rate and risk-weight a counterparty;
- (d) to monitor the condition of individual financings;
- (e) to administer its financing portfolio, including keeping the financing files current, getting up-to-date financial information on counterparties, and the electronic storage of important documents;



- (f) to ensure that the value of collateral and the value of the other CRM techniques used by an Islamic Bank are assessed regularly;
- (g) to assess whether its CRM techniques are effective; and
- (h) to calculate its Credit Risk Capital Requirement.

#### **6.9. Categories of financings**

- (1) An Islamic Bank must classify financings into 1 of the 5 categories in table 6.1. Nothing in the table prevents an Islamic Bank from classifying a financing under a higher risk category than the table requires.
- (2) An Islamic Bank must allocate all financing exposures to the same counterparty to the same risk category.

**Table 6.1 Categories of credit**

Item	Category	Description
1	performing	In this category, there is no uncertainty about timely repayment of the outstanding amounts. This category comprises financings that are currently in regular payment status with prompt payments.
2	special mention	<p>This category comprises:</p> <ul style="list-style-type: none"> <li>(a) financings with deteriorating or potentially deteriorating credit quality that may adversely affect the counterparty's ability to make scheduled payments on time;</li> <li>(b) financings that are 30 to 90 days in arrears;</li> <li>(c) financings showing weakness arising from the customer's financial position;</li> <li>(d) financings affected by market circumstances or any other industry-related concerns; and</li> <li>(e) financings that have been restructured and are not classified into a higher risk category.</li> </ul>
3	substandard	<p>This category comprises:</p> <ul style="list-style-type: none"> <li>(a) financings that show definite deterioration in credit quality and impaired repayment ability of the counterparty; or</li> <li>(b) financings that are 91 to 180 days in arrears.</li> </ul>
4	doubtful	<p>This category comprises:</p> <ul style="list-style-type: none"> <li>(a) financings that show significant quality deterioration, worse than those in the substandard category, to the extent that the prospect of full recovery of all the outstanding amounts is questionable and the probability of a loss is high (though the exact amount of loss cannot be determined yet); or</li> </ul>



		(b) financings that are 181 to 270 days in arrears.
5	loss	<p>This category comprises:</p> <p>(a) financings that are assessed as uncollectable;</p> <p>(b) financings where the probability of recovering the amount due is very low; or</p> <p>(c) financings that are more than 270 days in arrears.</p>

#### 6.10. Policy on Non-performing assets

An Islamic bank's Credit Risk management policy must facilitate the Islamic Bank's collection of past-due obligations, and its management of problem assets through:

- (a) monitoring of their credit quality;
- (b) early identification and ongoing oversight; and
- (c) review of their classification, provisioning and write-offs.

#### 6.11. Impaired financings

- (1) Impaired financing means a financing that is categorised as substandard, doubtful or loss.
- (2) A large exposure that is an impaired financing must be managed individually in terms of its valuation, categorisation and provisioning.
- (3) The review of impaired financings and other problem assets may be done individually, or by class, but must be done at least once a month.

#### 6.12. Restructuring, refinancing and re-provisioning of credits

- (1) A financing is a restructured financing if it has been re-aged, extended, deferred, renewed, rewritten or placed in a workout program. Unless there is good reason to do so, a restructured financing can never be classified as performing.
- (2) A restructured financing may be reclassified to a more favourable category, but only by 1 rating up from its category before the restructure. The financing may be reclassified 1 further category up after 180 days of satisfactory performance under the terms of the new contract.
- (3) The refinancing of a special mention or impaired financing must not be used to reclassify the financing to a more favourable category.
- (4) The AFSA may require a special mention financing to be managed individually, and may set a higher level of provision for the financing, if the AFSA is of the view that market circumstances or any other industry-related concerns require such action.

#### 6.13. Using external credit rating agencies (ECRA)

- (1) An Islamic Bank must use only a solicited Credit Risk rating determined by an ECRA.



- (2) A rating is a solicited rating if the rating was initiated and paid for by the issuer of the instrument, the rated counterparty or any other entity in the same corporate group as the issuer or rated counterparty.
- (3) An Islamic Bank must use the ratings determined by an ECRA consistently and in accordance with these rules and its Credit Risk management policy.
- (4) A firm that chooses to use ratings determined by an ECRA for exposures belonging to a class must consistently use those ratings for all the exposures belonging to that class. An Islamic Bank must not selectively pick between ECRAs or ratings in determining risk-weights.
- (5) Unsolicited ratings must not be used except with the written approval of the AFSA or in accordance with a direction of the AFSA. The AFSA may give a written direction setting out conditions that must be satisfied before a firm may use an unsolicited rating.
- (6) An Islamic Bank must ensure that the relevant rating takes into account the total amount of the exposure.

### Guidance

- i) In the standardised approach, external credit ratings from ECRAs are used in determining the risk-weights for exposures to:
  - (a) sovereigns
  - (b) central banking institutions
  - (c) public sector enterprises
  - (d) banks and other financial institutions
  - (e) corporates.
- ii) External credit ratings from ECRAs are not used in relation to:
  - (a) regulatory retail portfolios
  - (b) residential real estate financing
  - (c) non-performing financing
  - (d) high risk exposures.

### 6.14. Multiple assessments

- (1) If there is only 1 assessment by an ECRA for a particular claim, that assessment must be used to determine the risk-weight of the claim.
- (2) If there are 2 assessments by ECRAs and the assessments map into different risk-weights, the higher risk-weight must be applied.
- (3) If there are 3 or more assessments with different risk-weights, the assessments corresponding to the 2 lowest risk-weights should be referred to and the higher of those 2 risk-weights must be applied.



**6.15. Choosing between issuer and issue ratings**

- (1) If an Islamic Bank invests in an instrument with an issue-specific rating, the risk-weight to be applied to the instrument must be based on that rating.
- (2) If an Islamic Bank invests in an unrated instrument and the issuer of the instrument is assigned a rating that results in a lower risk-weight than the risk-weight normally applied to an unrated position, an Islamic Bank may apply the lower risk-weight to the instrument but only if the claim for the instrument has the same priority as, or is senior to, the claims to which the issuer rating relates. If the instrument is junior to the claims to which the issuer rating relates, an Islamic Bank must apply the risk-weight normally applied to an unrated position.
- (3) If an Islamic Bank invests in an unrated instrument and the issuer of the instrument is assigned a rating that results in a higher risk-weight than the risk-weight normally applied to an unrated position, an Islamic Bank must apply the higher risk-weight to the instrument if the claim for that instrument has the same priority as, or is junior to, the claims to which the issuer rating relates.

**6.16. Ratings within Financial Group**

An Islamic Bank must not use a Credit Risk rating for 1 entity in a Financial Group to determine the risk-weight for an unrated entity in the same group. If the rated entity has guaranteed the unrated entity's exposure to An Islamic Bank, the guarantee may be recognised for risk-weighting purposes if it satisfies the criteria for eligible Credit Risk mitigation.

**6.17. Using foreign currency and domestic currency ratings**

If an issuer rating is assigned to a counterparty and an Islamic Bank applies a risk-weight to an unrated position based on the rating of an equivalent exposure to the same counterparty:

- (a) An Islamic Bank must use that counterparty's domestic-currency rating for any exposure denominated in the currency of the counterparty's place of residence or incorporation; and
- (b) An Islamic Bank must use that counterparty's foreign-currency rating for any exposure denominated in a foreign currency.

**6.18. Using short-term ratings**

- (1) A short-term Credit Risk rating must be used only for short-term claims relating to banks and corporations (such as those arising from the issuance of commercial paper). The rating is taken to be issue-specific and must be used only to assign risk-weights for claims arising from a rated facility.
- (2) If a short-term rated exposure is assigned a risk-weight of 50%, an unrated short-term exposure to the same counterparty cannot be assigned a risk-weight lower than 100%.
- (3) If a short-term facility of an issuer is assigned a risk-weight of 150% based on the facility's Credit Risk rating, all unrated claims of the issuer (whether long-term or short-term) must be assigned a risk-weight of 150%.

**6.19. Risk-Weighted Assets (RWA) approach**

- (1) An Islamic Bank must apply risk-weights to its on-balance-sheet and off-balance-sheet items using the risk-weighted assets approach.





- (2) Risk-weights are based on credit ratings or fixed risk-weights and are broadly aligned with the likelihood of counterparty default. An Islamic Bank may use the ratings determined by an ECRA if allowed to do so by these rules.

#### **6.20. Relation to CRM techniques**

If a claim or asset to which a risk-weight must be applied by an Islamic Bank is secured by collateral or a guarantee (or there is a *Shari'ah*-compliant hedging instrument or netting agreement), the CRM techniques specified later in these Rules may be used to reduce an Islamic Bank's Credit Risk Capital Requirement.

#### **6.21. Risk-weight to be applied**

- (1) An Islamic Bank must apply the risk-weight set out in this section for a claim or asset.
- (2) An Islamic Bank must assess all financing exposures (rated or unrated) to determine whether the risk-weights applied to them are appropriate. The determination must be based on each exposure's inherent risk.
- (3) If there are reasonable grounds to believe that the inherent risk of an exposure is significantly higher than that implied by the risk-weight assigned to it, an Islamic Bank must consider the higher risk (and apply a higher risk-weight) in calculating the Credit Risk Capital Requirement.
- (4) An Islamic Bank must not rely only on a rating determined by an ECRA to assess the risks associated with an exposure. An Islamic Bank must also carry out its own Credit Risk assessment of each exposure.

#### **6.22. Commitments included in calculation**

An Islamic Bank must take into account all commitments in calculating its Credit Risk Capital Requirement, whether or not those commitments contain material adverse change clauses or other provisions that are intended to relieve an Islamic Bank of its obligations under particular conditions.

#### **6.23. AFSA can determine risk-weights and impose requirements**

- (1) Despite anything stated in these Module, the AFSA may determine the risk-weighted amount of a particular on-balance-sheet or off-balance-sheet item of an Islamic Bank if the AFSA considers that an Islamic Bank has not risk-weighted the item appropriately. The determination must be in writing.
- (2) The AFSA may also impose specific Capital Requirements or limits on significant risk exposures, including those that the AFSA considers to have not been adequately transferred or mitigated.

#### **6.24. Risk-Weighted Assets approach—on-balance-sheet items**

- (1) An Islamic Bank's total risk-weighted on-balance-sheet items is the sum of the risk-weighted amounts of each of its on-balance-sheet items.
- (2) The risk-weighted amount of an on-balance-sheet item is calculated by multiplying its exposure (after taking into account any applicable CRM technique) by the applicable risk-weight set out in table 6.2.





- (3) If column 3 of table 6.2 states that the risk-weight is “based on ECRA rating”, the applicable risk-weight for the claim or asset is that set out in table 6.3. If a claim’s or asset’s risk-weight is to be based on the ECRA rating and there is no such rating from an ECRA, an Islamic Bank must apply the risk-weight set out in the last column of table 6.3.
- (4) For table 6.2, investment property is land, a building or part of a building (or any combination of land and building) held to earn rentals or for capital appreciation or both.
- (5) Investment property does not include property held for use in the production or supply of goods or services, for administrative purposes, or for sale in the ordinary course of business. A real estate asset owned by an Islamic Bank as a result of a counterparty default is treated as ‘other item’ and risk-weighted at 100% but only for a period of 3 years starting from the date when an Islamic Bank records the asset on its books.

**Table 6.2 Risk-weights for on-balance-sheet items**

Item	Description of Claim or Asset	Risk-Weight, %
1	Cash	
	(a) notes, gold bullion	0
	(b) cash items in the process of collection	20
2	Claims on sovereigns	0
	(a) claims on Kazakhstan and on National Bank of Kazakhstan	0
	(b) claims on other sovereigns including respective central banks	based on ECRA rating
3	Claims on public sector enterprises	
	(a) non-commercial public sector enterprises in Kazakhstan	0
	(b) non-commercial public sector enterprises in other countries—non-relevant domestic currency	based on ECRA rating
	(c) other sovereign non-commercial public sector enterprises	based on ECRA rating
	(d) commercial public sector enterprises	based on ECRA rating
4	Claims on multilateral development banks	
	(a) multilateral development banks eligible for 0% risk-weight	0



	(b) other multilateral development banks	based on ECRA rating
5	Claims on banks (financial undertakings)	
	(a) claims on banks with an original maturity of more than 3 months	based on ECRA rating
	(b) claims on banks with an original maturity of 3 months or less	based on ECRA rating
6	Claims on securities and investment entities	
	(a) claims on securities and investment entities that are subject to capital requirements similar to Islamic banks	based on ECRA rating
	(b) claims on securities and investment entities that are not subject to capital requirements similar to Islamic banks	based on ECRA rating
7	Claims on corporates	based on ECRA rating
8	Claims on small and medium enterprises	100
9	Claims on securitisation exposures	based on ECRA rating
10	Claims secured against real estate financing	
	(a) residential real estate financings	
	(i) if the financing-to-value ratio is 0% to 80%	35
	(ii) if the financing-to-value ratio is more than 80% but less than 100%	75
	(iii) if the financing-to-value ratio is 100% or more	100
	(b) commercial real estate financings	100
11	Unsettled and failed transactions—delivery-versus-payment transactions	
	(a) 5 to 15 days	100
	(b) 16 to 30 days	625
	(c) 31 to 45 days	937.5



	(d) 46 or more days	1250
12	Unsettled and failed transactions—non-delivery-versus-payment transactions	100
13	Investments in funds	
	(a) rated funds	based on ECRA rating
	(b) unrated funds that are listed	100
	(c) unrated funds that are unlisted	150
14	Equity exposures	
	(a) equity exposures that are not deducted from capital and are listed on a recognised exchange	300
	(b) equity exposures that are not deducted from capital and are not listed on a recognised exchange	400
15	Investment property	400
16	All other items	100

**Table 6.3 Risk-weights based on ratings determined by ECRAs**

#### Guidance

In table 6.3, the ratings are given according to Standard & Poor's conventions. If a claim or asset is not rated by Standard & Poor's, its ratings must be mapped to the equivalent Standard & Poor's rating.

item	Description of claim or asset	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	below B-	unrated
1	claims on other sovereigns including respective central banks	0	20	50	100	100	150	100
2	claims on non-commercial public sector enterprises in other countries—non-relevant	0	20	50	100	100	150	100



	domestic currency							
3	claims on other sovereign non- commercial public sector enterprises	20	50	100	100	100	150	100
4	claims on commercial public sector enterprises	20	50	100	100	100	150	100
5	claims on multilateral development banks not eligible for 0% risk-weight	20	50	50	100	100	150	50
6	claims on banks with an original maturity of more than 3 months	20	50	50	100	100	150	50
7	claims on banks with an original maturity of 3 months or less	20	20	20	50	50	150	20
8	claims on securities and investment entities that are subject to capital requirements similar to Islamic banks	20	50	50	100	100	150	50
9	claims on securities and investment entities that are not subject to capital requirements similar to Islamic banks	20	50	100	100	150	150	100
10	claims on corporates	20	50	100	100	150	150	100
11	securitisation exposures	50	100	100	150	150	250	150



12	investments in rated funds	20	50	100	100	150	150	n/a
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#### 6.25. Specialised financing

- (1) A specialised financing exposure is risk-weighted at one rating less favourable than the rating that would apply, under table 6.3, to the counterparty to the transaction (or to the party to whom that counterparty has the right of recourse).
- (2) Specialised financing is a financing transaction that complies with the following requirements:
  - (a) the purpose of the financing is to acquire an asset;
  - (b) the cash flow generated by the collateral is the financing's exclusive (or almost exclusive) source of repayment;
  - (c) the financing represents a significant liability in the client's capital structure;
  - (d) the Credit Risk is determined primarily by the variability of the cash flow generated by the collateral (rather than the independent capacity of a broader commercial enterprise).

#### Guidance

Specialised financing is associated with the financing of projects where the repayment depends on the performance of the underlying collateral. There are 5 sub-classes of specialised financing:

- (a) project finance—financing industrial projects based on the projected cash flows of the project;
- (b) object finance—financing physical assets based on the projected cash flows obtained primarily through the rental or lease of the assets;
- (c) commodities finance—financing the reserves, receivables or inventories of exchange-traded commodities where the exposure is paid back based on the sale of the commodity (rather than by the borrower from independent funds);
- (d) income-producing real estate finance—financing real estate that is usually rented or leased out by the debtor to generate cash flow to repay the exposure; and
- (e) high-volatility commercial real estate finance—financing commercial real estate which demonstrates a much higher volatility of loss rates compared to other forms of specialised financing.

#### 6.26. Risk-weights for unsecured part of claim that is past due for more than 90 days

- (1) The risk-weight for the unsecured part of a claim (other than a claim secured by an eligible residential real estate financing) that is past due for more than 90 days is:
  - (a) 150% if the specific provisions are less than 20% of the past due claim;
  - (b) 100% if the specific provisions are 20% or more, but less than 50%, of the past due claim; or



- (c) 50% if the specific provisions are 50% or more of the past due claim.
- (2) The risk-weight for the unsecured part of a claim secured by an eligible residential real estate financing that is past due for more than 90 days is:
  - (a) 100% if the specific provisions are less than 20% of the past due claim; or
  - (b) 50% if the specific provisions are 20% or more of the past due claim.
- (3) In this rule, eligible residential real estate financing means a financing on a residential property that is, or will be:
  - (a) occupied by the counterparty for residential use; or
  - (b) rented out (on a non-commercial basis) for residential use.

**6.27. Risk-Weighted Assets approach—off-balance-sheet items**

- (1) An Islamic bank's total risk-weighted off-balance-sheet items is the sum of the risk-weighted amounts of its market-related and non-market-related off-balance-sheet items. An off-balance-sheet item must be converted to a Credit Equivalent Amount before it can be risk-weighted.
- (2) The risk-weighted amount of an off-balance-sheet item is calculated as follows:
  - (a) first, convert the notional principal amount of the item to its on-balance-sheet equivalent (Credit Equivalent Amount).
  - (b) second, multiply the resulting Credit Equivalent Amount by the risk-weight in Rule 6.24 (Risk-weighted assets approach—on-balance-sheet items) applicable to the claim or asset.
- (3) An Islamic Bank must include all market-related off-balance-sheet items (including on-balance-sheet unrealised gains on market-related off-balance-sheet items) in calculating its risk-weighted financing exposures.
- (4) A market-related item must be valued at its current market price.

**6.28. Conversion of notional amounts—market-related items**

- (1) An Islamic Bank must calculate the Credit Equivalent Amount of each of its market-related items. Unless the item is covered by an eligible netting agreement, the Credit Equivalent Amount of a market-related off-balance-sheet item is the sum of the current financing exposure and the potential future financing exposure from the item.
- (2) Current financing exposure is the absolute mark-to-market value (or replacement cost) of the item.
- (3) Potential future financing exposure (also known as 'the add-on') is the amount calculated by multiplying the notional principal amount of the item by the relevant Credit Conversion Factor in table 6.4. *The* notional principal amount of an item is the reference amount used to calculate payment streams between counterparties to the item.


**Table 6.4 Credit conversion factors for market-related off-balance-sheet items**

Item	Description of Claim or Asset	Credit Conversion Factor, %
1	profit rate contracts	
	(a) residual maturity 1 year or less	0
	(b) residual maturity > 1 year to 5 years	0.5
	(c) residual maturity > 5 years	1.5
2	foreign exchange, gold and silver contracts	
	(a) residual maturity 1 year or less	1
	(b) residual maturity > 1 year to 5 years	5
	(c) residual maturity > 5 years	7.5
3	equity contracts	
	(a) residual maturity 1 year or less	6
	(b) residual maturity > 1 year to 5 years	8
	(c) residual maturity > 5 years	10
4	precious metal contracts (other than gold and silver)	
	(a) residual maturity 1 year or less	7
	(b) residual maturity > 1 year to 5 years	7
	(c) residual maturity > 5 years	8
5	other commodity contracts (other than precious metals)	
	(a) residual maturity 1 year or less	10
	(b) residual maturity > 1 year to 5 years	12
	(c) residual maturity > 5 years	15
6	other market-related contracts	
	(a) residual maturity 1 year or less	10
	(b) residual maturity > 1 year to 5 years	12
	(c) residual maturity > 5 years	15



- (4) A potential future financing exposure must be based on an effective, rather than an apparent, notional principal amount. If the stated notional principal amount of an item is leveraged or enhanced by the structure of the item, an Islamic Bank must use the effective notional principal amount in calculating the potential future financing exposure.
- (5) No potential future financing exposure is calculated for a single-currency floating/floating profit rate swap. The financing exposure from such a profit rate swap must be based on mark-to-market values.

**6.29. Credit Conversion Factors for items with terms subject to reset**

- (1) For an item that is structured to settle outstanding exposures after specified payment dates on which the terms are reset (that is, the mark-to-market value of the item becomes zero on the specified dates), the period up to the next reset date must be taken to be the item's residual maturity. For a profit rate item of that kind that is taken to have a residual maturity of more than 1 year, the Credit Conversion Factor to be applied must not be less than 0.5% even if there are reset dates of a shorter maturity.
- (2) For an item with 2 or more exchanges of principal, the Credit Conversion Factor must be multiplied by the number of remaining exchanges under the item.

**6.30. Credit Conversion Factors for single-name swaps**

- (1) The Credit Conversion Factors for a protection buyer in a single-name total-rate-of-return swap are set out in column 3 of table 6.5. The Credit Conversion Factors for a protection seller are set out in column 4 of that table.
- (2) The protection seller in a single-name total-rate-of-return swap is subject to the add-on factor for a closed-out single-name swap only if the protection buyer becomes insolvent while the underlying asset is still solvent. The add-on must not be more than the amount of unpaid premiums.
- (3) In this rule, qualifying reference obligation includes obligations arising from items relating to:
  - (a) securities that are rated investment grade by at least 2 ECRAs; or
  - (b) securities that are unrated (or rated investment grade by only 1 ECRA), but:
    - (i) are approved by the AFSA, on application by the Islamic Bank, to be of comparable investment quality; and
    - (ii) are issued by an issuer that has its equity included in a main index used in a recognised exchange.

**Table 6.5 Credit conversion factors for single-name total-rate-of-return swaps**

Item	Type of Swap	Protection Buyer, %	Protection Seller, %
1	with qualifying reference obligation	5	5
2	with non-qualifying reference obligation	10	10





### 6.31. Policies for foreign exchange rollovers

- (1) An Islamic Bank must have policies for entering into and monitoring rollovers on foreign exchange transactions. The policies must restrict an Islamic Bank's capacity to enter into such rollovers, and must be approved by the AFSA.
- (2) An Islamic Bank must notify the AFSA if it enters into a rollover outside the approved policy. The AFSA may direct how the rollover is to be treated for capital adequacy purposes.
- (3) An Islamic Bank must not enter into a transaction at an off-market price, unless the transaction is a historical rate rollover on a foreign exchange transaction.
- (4) A historical rate rollover on a foreign exchange transaction may be entered into at an off-market price (instead of current market price).

### 6.32. Conversion of contracted amounts—non-market-related items

- (1) An Islamic Bank must calculate the Credit Equivalent Amount of each of its non-market-related items. Unless the item is a default fund guarantee in relation to clearing through a central counterparty, the Credit Equivalent Amount of a non-market-related off-balance-sheet item is calculated by multiplying the contracted amount of the item by the relevant Credit Conversion Factor in table 6.6.
- (2) If an Islamic Bank arranges a repurchase or reverse repurchase or a securities financing or borrowing transaction between a customer and a third party and provides a guarantee to the customer that the third party will perform its obligations, an Islamic Bank must calculate the Credit Risk Capital Requirement as if it were the principal.

**Table 6.6 Credit conversion factors for non-market-related off-balance-sheet items**

Item	Kind of item	Credit conversion factor, %
1	direct credit substitutes	100
2	performance-related contingencies	50
3	trade-related contingencies	20
4	financing of securities, or lodging securities as collateral	100
5	assets sold with recourse	100
6	forward asset purchases	100
7	partly paid shares and securities	100
8	placements of forward deposits	100
9	note issuance and underwriting facilities	50
10	commitments with certain drawdown	100



11	commitments with uncertain drawdowns (for example, undrawn formal standby facilities and credit lines) with an original maturity of 1 year or less	20
12	commitments with uncertain drawdowns with an original maturity of more than 1 year	50
13	commitments that can be unconditionally cancelled at any time without notice (for example, undrawn overdraft and credit card facilities for which any outstanding unused balance is subject to review at least once a year)	0

- (3) For item 4 of table 6.6, an exposure from financing securities, or lodging securities as collateral, may be treated as a collateralised transaction.

### 6.33. Credit Equivalent Amount of undrawn commitments

In calculating the Credit Equivalent Amount of a non-market-related off-balance-sheet item that is an undrawn (or partly drawn) commitment, an Islamic Bank must use the undrawn amount of the commitment.

### 6.34. Irrevocable commitment—off-balance-sheet facilities

For an irrevocable commitment to provide an off-balance-sheet facility, the original maturity must be taken to be the period from the commencement of the commitment until the associated facility expires.

#### Example

An irrevocable commitment with an original maturity of 6 months with an associated facility that has a nine-month term is taken to have an original maturity of 15 months.

### 6.35. Risk-weightings for Islamic Financial Contracts

The Rules in the rest of this chapter describe and set out the risk-weights applicable to the main types of Islamic financial contracts employed in carrying out Islamic Banking Business. The risk-weight to be applied to the exposure under a contract of a particular type may differ:

- (a) at different stages of the contract; or
- (b) depending on the enterprise or asset to which the contract relates.

#### Sale-based contracts

### 6.36. Treatment of *murabahah* and related contracts

- (1) An Islamic Bank is exposed to Credit Risk under a *murabahah* contract if the obligor fails to pay the agreed selling price under the contract. Therefore, an Islamic Bank is subject to a capital charge for Credit Risk exposure once the asset is sold and payment is due to an Islamic Bank.



- (2) For an *murabahah* for the purchase orderer (MPO) contract, an Islamic Bank is exposed to Credit Risk if the obligor (purchase orderer) defaults on its obligation to purchase the asset. Because an Islamic Bank has recourse against the obligor to purchase the asset at the agreed price, the Credit Risk exposure commences once an Islamic Bank acquires the asset.
- (3) In an MPO contract, an Islamic Bank is also exposed to Credit Risk if the obligor fails to pay the agreed price in accordance with the agreed terms.

**Table 6.7A Credit Risk-weights for *murabahah***

Stage of Contract	Credit Risk-weight
asset available for sale and on firm's balance sheet	not applicable
asset has been sold and title transferred, and selling price is due to an Islamic Bank	based on the customer's type and rating under Rule 6.24

**Table 6.7B Credit risk-weights for MPO**

Stage of contract	Credit risk-weight
asset available for sale and on firm's balance sheet	based on the customer's type and rating under Rule 6.24, with the applicable risk-weight applied to the acquisition cost less any cash collateral
asset has been sold and title transferred, and selling price is due to firm	based on the customer's type and rating under Rule 6.24

**Table 6.7C Credit Risk-weights for MPO**

Stage of contract	Credit risk-weight
asset available for sale and on firm's balance sheet	based on the customer's type and rating under Rule 6.24, with the applicable risk-weight applied to the acquisition cost less any cash collateral
asset has been sold and title transferred, and selling price is due to firm	based on the customer's type and rating under Rule 6.24

### 6.37. Treatment of *bai bithaman ajil*

A *bai bithaman ajil* (BBA) contract is risk-weighted based on the customer's type and rating under Rule 6.24.

### 6.38. Treatment of *salam* and related contracts

- (1) Under a *salam* contract, an Islamic Bank is exposed to Credit Risk if the obligor fails to deliver the relevant commodity in accordance with the agreed terms.
- (2) An Islamic Bank undertaking parallel *salam* contracts is exposed to Credit Risk if the purchaser fails to pay for the relevant commodity. Nevertheless, if the seller under the



first *salam* contract fails to deliver the commodity, an Islamic Bank is not relieved of its obligation to deliver the commodity to the purchaser under the parallel *salam* contract.

- (3) An Islamic Bank must not net a *salam* exposure against a parallel *salam* exposure.

**Table 6.8A Credit Risk-weights for *salam* without parallel *salam***

Stage of contract	Credit risk-weight
firm is expected to delivery the commodity <i>salam</i> at an agreed time	based on the customer's type and rating under Rule 6.24

**Table 6.8B Credit Risk-weights for *salam* with parallel *salam***

Stage of contract	Credit risk-weight
<p>firm is expected to delivery the commodity <i>salam</i> at an agreed time</p> <p><i>Note: The parallel salam does not extinguish the requirement for capital from the first salam contract.</i></p>	based on the customer's type and rating under Rule 6.24

### 6.39. Treatment of *istisna* and related contracts

- (1) Under an *istisna* contract, an Islamic Bank is exposed to Credit Risk if the obligor fails to pay the price, whether during the manufacturing or construction stage, or on completion of the asset.
- (2) Under a parallel *istisna* contract, an Islamic Bank, as the purchaser of the asset, is exposed to Credit Risk if the seller fails to deliver the asset at the agreed time and in accordance with the initial *istisna* buyer's specification.
- (3) The parallel *istisna* seller's failure to deliver the asset does not discharge an Islamic Bank's obligation to deliver the asset to the obligor under the initial *istisna* contract. Thus, an Islamic Bank is also exposed to the potential loss of making good the shortcoming or acquiring the asset elsewhere.
- (4) An Islamic Bank must not net an *istisna* exposure against a parallel *istisna* exposure.

**Table 6.9A Credit Risk-weights for *istisna* without parallel *istisna***

Stage of contract	Credit risk-weight
unbilled work-in-process	100%
unpaid billed work-in-process	based on the ultimate customer's type and rating under Rule 6.24


**Table 6.9B Credit Risk-weights for *istisna* with parallel *istisna***

Stage of contract	Credit Risk-weight
unbilled work-in-process	based on the ultimate customer's type and rating under Rule 6.24
unpaid billed work-in-process	based on the ultimate customer's type and rating under Rule 6.24

### Lease-based contracts

#### 6.40. Treatment of *ijarah* and related contracts

- (1) An Islamic Bank that is the lessor under an *ijarah* contract is exposed to Credit Risk if the lessee fails to pay the rental amount in accordance with the agreement to lease.
- (2) In addition, an Islamic Bank is exposed to Credit Risk if the lessee (lease orderer) defaults on its obligation to lease the asset. In this situation, an Islamic Bank may lease or dispose of the asset to another party, but an Islamic Bank is also exposed to Credit Risk if the lessee is not able to compensate it for the losses incurred arising from the disposal of the asset.

**Table 6.10 Credit Risk-weights for *ijarah* and IMB contracts**

Stage of contract	Credit Risk-weight
asset available for lease and on firm's balance sheet	based on the lessee's type and rating under Rule 6.24
lease contract has become binding and rental payments due from lessee	based on the lessee's type and rating under Rule 6.24

### Equity-based contracts

#### 6.41. Treatment of *musharakah* (non-diminishing)

- (1) Except for diminishing *musharakah* contracts, all *musharakah* investments are treated as equity investments
- (2) As an equity investment, a *musharakah* investment must be risk-weighted in accordance with table 6.11A.

**Table 6.11A Credit Risk-weights for *musharakah* (non-diminishing)**

Item	Description of investment	Risk-weight, %
1	investments in funds	
	(a) rated funds	based on ECRA rating in table 6.11B
	(b) unrated funds that are listed	100



	(c) unrated funds that are unlisted	150
2	equity exposures	
	(a) equity exposures that are not deducted from capital and are listed on a recognised exchange	300
	(b) equity exposures that are not deducted from capital and are not listed on a recognised exchange	400, except if rule 6.41(3) applies
3	investment in real estate	400
4	investment in physical assets (such as commercial vehicles, passenger cars, ships, aircraft, railway machinery, computers, business machines and other types of equipment)	
	(a) if an Islamic Bank has majority ownership over the asset and can exit the investment at any time	300
	(b) if an Islamic Bank does not have majority ownership over the asset or cannot exit the investment at any time	400, except if rule 6.41(3) applies

**Table 6.11B Risk-weights for investments in rated funds based on ECRA ratings**

AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	below B-
20	50	100	100	150	150

### Guidance

In the table, the ratings are given according to Standard & Poor's conventions. If a claim or asset is not rated by Standard & Poor's, its ratings must be mapped to the equivalent Standard & Poor's rating.

- (3) The lower risk-weight of 300% applies to an investment that would normally be risk-weighted at 400% if, under the *musharakah* contract, the Islamic Bank is allowed to withdraw its participation within 5 days after giving notice of withdrawal. In any other case, an Islamic Bank may apply a risk-weight of 300% if it can demonstrate:
  - (a) that the lower risk-weight is appropriate for the nature, scale and complexity of an Islamic Bank's business;
  - (b) that an Islamic Bank can effectively participate in the management of the investment and that such participation would not unduly increase Operational Risk
  - (c) an Islamic Bank's ability to monitor the operations and performance of the investment;
  - (d) that the valuation methods and exit strategies used by an Islamic Bank are appropriate; and
  - (e) that an Islamic Bank has effective reporting and information-sharing systems.



#### 6.42. Treatment of diminishing *musharakah*

The risk-weight for a diminishing *musharakah* contract depends on the category of the enterprise or asset to which the contract relates.

**Table 6.12 Credit Risk-weights for diminishing *musharakah***

Enterprise or asset	Credit Risk-weight
private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities	not applicable
private commercial enterprise to undertake business venture other than trading activities in foreign exchange, shares or commodities	based on the customer's type and rating under Rule 6.24 (after customer agrees to buy out an Islamic Bank's share on the investment)
joint ownership of real estate or movable assets through <i>musharakah</i> with <i>murabahah</i> subcontract	based on the customer's type and rating under Rule 6.24
joint ownership of real estate or movable assets through <i>musharakah</i> with <i>ijarah</i> subcontract	based on the lessee's type and rating under Rule 6.24

#### 6.43. Treatment of *mudarabah* and related contracts

This rule applies to risk-weighting for an exposure arising from a *mudarabah* contract, except if the AFSA examines the exposure and determines it to be an equity investment. If the AFSA determines that the exposure is an equity investment, the risk-weights set out in rule 6.41 for *musharakah* apply.

**Table 6.13A Credit Risk-weights for *mudarabah* investments (other than project finance)**

Enterprise or asset	Credit Risk-weight
private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities	not applicable
private commercial enterprise to undertake business venture other than trading activities in foreign exchange, shares or commodities	before maturity: 400% of the contributed amount less any specific provisions (or 300% if the funds may be withdrawn by an Islamic Bank at short notice)  on maturity: after the <i>mudarib</i> has agreed to pay back an Islamic Bank's initial investment, based on the <i>mudarib</i> 's type and rating under Rule 6.24
placement in the interbank market	based on the customer's type and rating under Rule 6.24




**Table 6.13B Credit risk-weights for *mudarabah* investments in project finance**

Stage of contract	Credit risk-weight
before completion: unbilled work-in-process inventory	400% on unbilled inventory less any amount held in the repayment account
on completion: after certification from ultimate customer, where the amount is receivable by an Islamic Bank from the <i>mudarib</i> (for progress payment to the <i>mudarib</i> from the ultimate customer)	<p>based on the ultimate customer's type and rating under Rule 6.24</p> <p>or</p> <p>based on the <i>mudarib</i>'s type and rating under Rule 6.24:</p> <p>(a) for any amount already paid by the ultimate customer to the <i>mudarib</i>; or</p> <p>(b) if the <i>mudarib</i> undertakes to bear the default risk of the ultimate customer as part of the <i>mudarabah</i> contract</p>

#### Loan-based contracts

##### 6.44. Treatment of *qardh*

Under a *qardh* contract, an Islamic Bank is exposed to Credit Risk if the borrower fails to repay the principal amount in accordance with the contract. Hence, the Credit Risk exposure arises at the time the contract becomes binding.

**Table 6.14 Credit Risk-weights for *qardh***

Stage of contract	Credit Risk-weight
amount receivable from customer	based on the customer's type and rating under Rule 6.24

#### Service-based contracts

##### 6.45. Treatment of *wakalah*

An Islamic Bank is exposed to Credit Risk if an Islamic Bank enters into a financing contract based on *wakalah*.

**Table 6.15A Credit Risk-weights for *wakalah* investments (other than project finance)**

Enterprise or asset	Credit Risk-weight
private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities	not applicable
private commercial enterprise to undertake business venture other than trading activities in foreign exchange, shares or commodities	not applicable
placement in the interbank market	based on the customer's type and rating under Rule 6.24


**Table 6.15B Credit Risk-weights for *wakalah* investments in project finance**

Stage of contract	Credit Risk-weight
before completion: unbilled work-in-process inventory	400% on unbilled inventory
on completion: after certification from ultimate customer, where the amount is receivable by an Islamic Bank from the <i>wakeel</i> (for progress payment to the <i>wakeel</i> from the ultimate customer)	<p>based on the ultimate customer's type and rating under Rule 6.24</p> <p>or</p> <p>based on the <i>wakeel</i>'s type and rating under Rule 6.24:</p> <p>(a) for any amount already paid by the ultimate customer to the <i>wakeel</i>; or</p> <p>(b) if the <i>wakeel</i> undertakes to bear the default risk of the ultimate customer as part of the <i>wakalah</i> contract</p>

#### 6.46. Credit Risk Mitigation

- (1) An Islamic Bank is able to obtain capital relief by using *Shari'ah*-compliant CRM techniques. The techniques must be viewed as complementary to, rather than a replacement for, thorough Credit Risk assessment.
- (2) Eligible CRM techniques include:
  - (a) accepting collateral, standby letters of credit and guarantees;
  - (b) using *Shari'ah*-compliant hedging instruments; and
  - (c) using netting agreements.

#### Guidance

- i) Credit Risk mitigation using collateral and guarantees is usually dealt with at the time credit is granted. In contrast, hedging instruments and netting agreements are often used after the credit is granted, or used to manage an Islamic Bank's overall portfolio risk.
  - ii) An Islamic Bank should not rely excessively on collateral or guarantees to mitigate Credit Risk. While collateral or guarantees may provide secondary protection to an Islamic Bank if the counterparty defaults, the primary consideration for credit approval should be the counterparty's repayment ability.
  - iii) An Islamic Bank that provides real estate financing at high financing-to-value ratios should consider the need for alternative forms of protection against the risks of such financing, in order to protect itself against the risk of a fall in the value of the property.
- (3) In choosing a CRM technique, an Islamic Bank must consider:



- (a) an Islamic Bank's knowledge of, and experience in using, the technique;
- (b) the cost-effectiveness of the technique;
- (c) the type and financial strength of the counterparties or issuers;
- (d) the correlation of the technique with the underlying credits;
- (e) the availability, liquidity and realisability of the technique;
- (f) the extent to which documents in common use (for example, the ISDA Master Agreement) can be adopted; and
- (g) the degree of recognition of the technique by financial services regulators.

**6.47. Requirements—CRM techniques**

- (1) An Islamic bank's Credit Risk management policy must set out the conditions under which CRM techniques may be used. The policy must enable an Islamic Bank to manage CRM techniques and the risks associated with their use.
- (2) An Islamic Bank must analyse the protection given by CRM techniques to ensure that any residual Credit Risk is identified, measured, evaluated, managed and controlled or mitigated.
- (3) The policy must include procedures for:
  - (a) setting mark-up rates according to the risk rating of the counterparties;
  - (b) taking account of governing laws for contracts relating to financing transactions; and
  - (c) assessing the risks and obligations from an Islamic Bank's own exposures in parallel transactions such as those in *salam* and *istisna*.
- (4) If an Islamic Bank accepts collateral, its policy must state the types of collateral that it will accept, and the basis and procedures for valuing collateral.
- (5) If an Islamic Bank uses netting agreements, it must have a netting policy that sets out its approach. The netting policy must provide for monitoring netting agreements and must enable an Islamic Bank to monitor and report netted transactions on both gross and net bases.

**6.48. Obtaining capital relief**

- (1) To obtain capital relief, the CRM technique and every document giving effect to it must be binding on all parties and enforceable in all the relevant jurisdictions.

**Example**

When accepting collateral, an Islamic Bank must ensure that any necessary legal procedures have been followed, to ensure that the collateral can be enforced.

- (2) An Islamic Bank must review the enforceability of a CRM technique that it uses. An Islamic Bank must have a well-founded legal basis for any conclusion about enforceability, and must carry out further reviews to ensure that the technique remains enforceable.



- (3) The effects of a CRM technique must not be double-counted. An Islamic Bank is not allowed to obtain Capital relief if:
- (a) the risk-weight for the claim or asset is based on an issue-specific rating; and
  - (b) the ECRA that determined the rating had taken the technique into consideration in doing so.

### Guidance

An Islamic Bank should consider whether independent legal opinion should be sought on the enforceability of documents. The documents should be ready before an Islamic Bank enters into a contractual obligation or releases funds.

### 6.49. Standard haircuts to be applied

- (1) An Islamic Bank must use the standard haircuts (expressed in percentages) set out in tables 6.16A and 6.16B in any calculation relating to Credit Risk mitigation. The haircuts are applied after risk mitigation to calculate adjusted exposures and are intended to take into account possible future price fluctuations.
- (2) In table 6.16A:

*other issuers* include banks, corporates, and public sector enterprises that are not treated as sovereigns.

*sovereign* includes a multilateral development bank, and a non-commercial public sector enterprise, that has a zero per cent risk-weight.

**Table 6.16A Haircuts for *sukuk***

Item	Credit rating for debt securities	Residual maturity, %	Sovereigns, %	Other issuers, %
1	AAA to AA-/A-1 (long-term and short-term)	≤1 year	0.5	1
		>1 year, ≤ 5 years	2	4
		> 5 years	4	8
2	A+ to BBB-/ A-2/A-3/P-3 (long-term and short-term)	≤1 year	1	2
		>1 year, ≤ 5 years	3	6



		> 5 years	6	12
3	BB+ to BB- (long-term)	All	15	25
4	unrated	All	25	25

**Table 6.16B Haircuts for other instruments**

Item	Description of instrument	Haircut, %
1	main index equities (including convertible bonds) and gold	15
2	other equities (including convertible bonds) listed on a recognised exchange	25
3	units in Islamic collective investment schemes	depending on underlying assets, as above
4	physical assets pledged in accordance with rule 4.6.9	30
5	units in listed trusts, undertakings for collective investments in transferable securities ( <b>UCITS</b> ), mutual funds and tracker funds	highest haircut applicable to any security in which the entity can invest
6	cash collateral denominated in the same currency as the collateralised exposure	0
7	a CRM technique with a currency mismatch	8

- (3) For item 7 of table 6.16B, if a guarantee is denominated in a currency different from that in which the exposure is denominated (that is, there is a **currency mismatch**), the amount of the exposure that is covered must be reduced using the following formula:

$$G \times (1 - Hfx)$$

where:

**G** is the nominal amount of the guarantee.

**Hfx** is 8% or the haircut under whichever of subrule (1) or (4) applies.

Depending on the frequency of the revaluation of the guarantee, the 8% haircut (which is based on a 10-business-day holding period) must be scaled up using the following formula:

$$H = H_{10} \sqrt{\frac{N+9}{10}}$$



where:

$H$  is the scaled-up haircut.

$H_{10}$  is the standard haircut under Table 6.16A or 6.16B.

$N$  is the number of business days between revaluations for secured transactions.

- (4) If the mismatched currencies are both pegged to the same reference currency, or if 1 of them is pegged to the other,  $Hfx$  is zero (and no haircut applies).

## Collateral

### 6.50. Capital relief from collateral

- (1) An Islamic Bank may obtain capital relief by accepting *Shari'ah*-compliant eligible collateral.
- (2) Collateral may be lodged by the counterparty of an Islamic Bank holding a credit exposure (or by a third party on behalf of the counterparty).
- (3) An Islamic Bank must enter into a written agreement with the party lodging the collateral. The agreement must establish an Islamic Bank's direct, explicit, irrevocable and unconditional recourse to the collateral.

#### Guidance

In the case of cash collateral, the recourse may be in the form of a contractual right of set-off on credit balances. A common-law right of set-off is, on its own, insufficient to satisfy this rule.

- (4) If collateral is lodged by a third party, the third party must guarantee the counterparty's obligation to an Islamic Bank and must indemnify an Islamic Bank if the counterparty fails to fulfil its obligation. An Islamic Bank must ensure that the guarantee does not fail for lack of consideration.
- (5) The mechanism by which collateral is lodged must allow an Islamic Bank to liquidate or take possession of the collateral in a timely way. An Islamic Bank must take all steps necessary to satisfy the legal requirements applicable to its interest in the collateral.
- (6) There must not be a significant positive correlation between the value of the collateral and the credit quality of the borrower.

#### Guidance

- (1) An Islamic Bank should have clear and robust procedures for the liquidation of collateral to ensure that the legal conditions for declaring default and liquidating the collateral are observed.
- (2) An Islamic Bank should consider whether, in the event of default, notice to the party that lodged the collateral would be needed before an Islamic Bank could have recourse to it.

### 6.51. Valuing collateral

Collateral accepted by an Islamic Bank must be valued at its net realisable value, taking into account prevailing market conditions. That value must be monitored at appropriate intervals, and the collateral must be regularly revalued.



**Guidance**

- (1) The net realisable value of some collateral may be readily available (for example, collateral that is marked-to-market regularly). Other collateral may be more difficult to value and may require knowledge and consideration of prevailing market conditions.
- (2) The method and frequency of monitoring and revaluation depend on the nature of the collateral. For example, commercial property might be revalued every year, whereas securities accepted as collateral are usually marked-to-market daily. Residential property may not need to be revalued every year, but information should be sought about general market conditions.

**6.52. Eligible collateral for Islamic banks**

- (1) The following are eligible collateral if they satisfy the criteria in (2) below:
  - (a) gold bullion;
  - (b) cash;
  - (c) *hamish jiddiyah* or refundable security deposit taken by an Islamic Bank against damages if:
    - (i) a purchase orderer in an MPO contract defaults on its obligation to purchase the asset; or
    - (ii) a lease orderer in an *ijarah* contract defaults on its obligation to lease the asset;
  - (d) urbun or earnest money held by a firm as collateral to guarantee contract performance;
  - (e) *sukuk* that are assigned, by an ECRA, a rating of:
    - (i) for sovereign or non-commercial public sector enterprise securities that are eligible for zero per cent risk-weight—at least BB-;
    - (ii) for short-term debt securities—at least A-3/P-3; or
    - (iii) for any other securities—at least BBB-;
  - (f) subject to sub-rule (3), *sukuk* that have not been assigned a rating by an ECRA, if:
    - (i) the securities are issued by an Islamic Bank (or by a conventional bank that is outside the AIFC and that has an Islamic window or Subsidiary operation) as senior debt and are listed on a recognised exchange;
    - (ii) all rated issues of the same seniority issued by that firm or bank have a credit rating of at least BBB- (for long-term debt instruments) or A-3/P-3 (for short-term debt instruments); and
    - (iii) an Islamic Bank or bank and the holder of the collateral have no information suggesting that the securities should have a rating below BBB- or A 3/P-3;
  - (g) *Shari'ah*-compliant equities (including convertible bonds) that are included in a main index;





- (h) units in Islamic collective investment schemes;
  - (i) tracker funds, mutual funds and undertakings for collective investments in transferable securities (UCITS) if:
    - (i) a price for the units is publicly quoted daily; and
    - (ii) the funds or UCITS are limited to investing in instruments listed in (i);
  - (j) *Shari'ah*-compliant equities (including convertible bonds) that are not included in a main index but are listed on a recognised exchange, and funds and UCITS described in paragraph (i) that include such equities.
- (2) For collateral to be eligible collateral, it must be lodged for at least the life of the exposure, and must be marked-to-market at least once every 6 months. The release of collateral must be conditional on the repayment of the exposure, but collateral may be reduced in proportion to the amount of any reduction in the exposure.
- (3) Collateral in the form of securities issued by the counterparty or a person connected to the counterparty is not eligible collateral.
- (4) Takaful contracts, put options, and forward sales contracts or agreements are not eligible collateral.

#### 6.53. When physical assets may be eligible collateral

- (1) An Islamic Bank may accept as **eligible collateral**, by way of pledge, a specified asset that can be lawfully owned, and is saleable and deliverable. The pledge must be enforceable and the asset must be free of encumbrance.
- (2) An asset leased under an *ijarah* or IMB contract may be repossessed by an Islamic Bank as lessor in case of default by the lessee. As such, it fulfils the function of collateral for purposes of Credit Risk mitigation.

#### 6.54. Forms of cash collateral

**Cash collateral**, in relation to a financing exposure, means collateral in the form of:

- (a) PSIAs, notes or coins on deposit with an Islamic Bank holding the exposure, if supported by an agreement that gives an Islamic Bank the right of set-off against the amount of receivables due from the customer;
- (b) certificates of deposit, bank bills and similar instruments issued by the Islamic Bank holding the exposure; or
- (c) cash-funded credit-linked notes issued by an Islamic Bank against exposures in its Banking Book, if the notes satisfy the criterion for *Shari'ah*-compliant hedging instruments.

#### 6.55. Holding eligible collateral

- (1) Eligible collateral must be held by:
- (a) an Islamic Bank;
  - (b) a branch of an Islamic Bank;



- (c) an entity that is a member of the financial group of which an Islamic Bank is a member;
  - (d) an independent custodian; or
  - (e) a central counterparty.
- (2) The holder of cash collateral in the form of a certificate of deposit or bank bill issued by an Islamic Bank must keep possession of the instrument while the collateralised exposure exists.
- (3) If the collateral is held by an independent custodian or central counterparty, an Islamic Bank must take reasonable steps to ensure that the holder segregates the collateral from the holder's own assets.
- (4) If collateral is held by a branch of an Islamic Bank which is not regulated by the AFSA, the agreement between an Islamic Bank and the party lodging the collateral must require the branch to act in accordance with the agreement.

**6.56. Risk-weight for cash collateral**

- (1) An Islamic Bank may apply a zero per cent risk-weight to cash collateral if the collateral is held by an Islamic Bank itself.
- (2) An Islamic Bank may apply a zero per cent risk-weight to cash collateral held by another member of the financial group of which an Islamic Bank is a member if the agreement between an Islamic Bank and the party lodging the collateral requires the holder of the collateral to act in accordance with the agreement.
- (3) If cash collateral is held by another Islamic Bank under a non-custodial arrangement, and the collateral is lodged with an Islamic Bank under an agreement that establishes an Islamic Bank's irrevocable and unconditional recourse to the collateral, the exposure covered by the collateral (after any necessary haircuts for currency risk) may be assigned the risk-weight of an Islamic Bank holding the collateral.
- (4) If cash collateral is held by an independent custodian (other than a central counterparty), the risk-weight of the holder of the collateral must be used. However, an Islamic Bank may apply a zero per cent risk-weight to notes and coins held by an independent custodian.

**6.57. Risk-weight for claims**

- (1) The secured part of a claim must be risk-weighted at whichever is the higher of 20% and the risk-weight applicable to the eligible collateral. However, a risk-weight lower than 20% may be applied to the secured part if rule 6.58 applies.
- (2) The unsecured part of the claim must be weighted at the risk-weight applicable to the original counterparty.

**6.58. Risk-weights less than 20%**

- (1) A zero per cent risk-weight may be applied to a collateralised transaction if:
  - (a) there is no currency mismatch; and
  - (b) any one of the following applies:



- (i) the collateral is in the form of sovereign securities;
  - (ii) the collateral is in the form of cash collateral on deposit with the Islamic Bank; or
  - (iii) if the collateral is in the form of non-commercial public sector enterprise securities, then the securities must be eligible for zero per cent risk-weight and the market value of the collateral must be discounted by 20%.
- (2) A zero per cent risk-weight may be applied to an OTC *Shari'ah*-compliant hedging transaction if there is no currency mismatch and the transaction is fully collateralised by cash and marked-to-market daily.
- (3) A 10% risk-weight may be applied to an OTC *Shari'ah*-compliant hedging transaction to the extent that the transaction is collateralised by sovereign or non-commercial public sector enterprise securities that are eligible for zero per cent risk-weight.

## Guarantees

### 6.59. Capital relief from guarantees

- (1) Capital relief is allowed from a guarantee if the guarantor is an eligible guarantor and the guarantee satisfies the criteria in (2) to (4) below. Before accepting a guarantee, an Islamic Bank must consider the guarantor's legal and financial ability to fulfil the guarantee.
- (2) A guarantee must be a direct claim on the guarantor and must clearly state the extent of the cover. A letter of comfort is not a guarantee for the purposes of this Division.
- (3) A guarantee must be irrevocable. It must not include a term or condition:
  - (a) that allows the guarantor to cancel it unilaterally; or
  - (b) that increases the effective cost of cover if the credit quality of the guaranteed exposure deteriorates.
- (4) A guarantee must be unconditional. It must not include a term or condition (outside the direct control of an Islamic Bank) that allows the guarantor not to indemnify an Islamic Bank in a timely way if the counterparty defaults.
- (5) If a claim on a counterparty is secured by a guarantee, the part of the claim that is covered by the guarantee may be weighted at the risk-weight applicable to the guarantor. The unsecured part of the claim must be weighted at the risk-weight applicable to the original counterparty.

## Guidance

- i) The irrevocability condition does not require that the guarantee and the exposure be maturity matched. However, it does require that the agreed maturity should not be reduced by the guarantor after the Islamic Bank accepts the guarantee.
- ii) This rule applies to a guarantee that provides part coverage under which an Islamic Bank and the guarantor share losses on a pro-rata basis.



**6.60. Eligible guarantors**

- (1) **Eligible guarantor** means:
  - (a) Republic of Kazakhstan, any other sovereign or any entity treated as a sovereign; or
  - (b) any entity (including a public sector enterprise not treated as a sovereign) that has:
    - (i) a risk-weight of 20% or lower; and
    - (ii) a lower risk-weight than the counterparty.
- (2) A parent entity, Subsidiary or affiliate of a counterparty may be an eligible guarantor if it has a lower risk-weight than the counterparty.

**Shari'ah-compliant hedging instruments**

**6.61. Capital relief from hedging instruments**

- (1) Capital relief is allowed if an Islamic Bank uses a *Shari'ah*-compliant hedging instrument. Each of the following is a **Shari'ah-compliant hedging instrument** if it satisfies (2) below:
  - (a) a total-rate-of-return swap for which an Islamic Bank has recorded any deterioration in the value of the underlying exposure, in addition to recording the net payments received on the swap as net income;
  - (b) a cash-funded credit-linked note;
  - (c) a first and second-to-default hedging instrument basket product.
- (2) The hedging instrument must not include a term or condition that terminates the credit protection, or increases an Islamic Bank's costs for the protection, if the credit quality of the underlying exposure deteriorates.
- (3) If a claim on a counterparty is protected by a *Shari'ah*-compliant hedging instrument, the part of the claim that is protected may be weighted at the risk-weight applicable to the issuer of the instrument. The unprotected part of the claim must be weighted at the risk-weight applicable to the original counterparty.

**Netting agreements**

**6.62. Capital relief from netting agreements**

- (1) An Islamic Bank is able to obtain capital relief from a netting agreement with a counterparty only if the agreement is an eligible netting agreement.
- (2) An Islamic Bank that has entered into a netting agreement must consistently net all the transactions included in the agreement. An Islamic Bank must not selectively pick which transactions to net.
- (3) The following kinds of transactions may be netted:
  - (a) financing assets and deposits, but only if:



- (i) an Islamic Bank is able to determine, at all times, the assets and deposits that are subject to netting under the agreement; and
    - (ii) the deposits satisfy the criteria for eligible collateral;
  - (b) securities financing transactions;
  - (c) OTC *Shari'ah*-compliant hedging transactions.
- (4) The transactions listed in Rule (3) above may be netted across both the Banking and Trading Books of an Islamic Bank, if the netted transactions satisfy the criteria in rule 6.63 and across different market-related products to the extent that they are recognised as market-related transactions.

#### Guidance

- i) Securities financing transactions are not included as part of market-related transactions.
- ii) A netting agreement may include the netting of OTC *Shari'ah*-compliant hedging transactions:

#### 6.63. Criteria for eligible netting agreements

- (1) To be an ***eligible netting agreement***, a netting agreement:
  - (a) must be in writing;
  - (b) must create a single obligation covering all transactions and collateral included in the agreement and giving the Islamic Bank the following rights:
    - (i) the right to terminate and close-out, in a timely way, all the transactions included in the netting agreement;
    - (ii) the right to net the gains and losses on those transactions (including the value of any collateral) so that an Islamic Bank either has a claim to receive, or an obligation to pay, only the net sum of the close-out values of the individual transactions;
    - (iii) the right to liquidate or set-off collateral if either party to the agreement fails to meet its obligations because of default, liquidation, bankruptcy or other similar circumstances;
  - (c) must not be subject to a walkaway clause; and
  - (d) must be supported by a written and reasoned legal opinion that complies with rules 6.64 to 6.65.
- (2) An Islamic Bank must not recognise a netting agreement as an eligible netting agreement if it becomes aware that a financial services regulator of the counterparty is not satisfied that the agreement is enforceable under the laws of the regulator's jurisdiction. This rule applies regardless of any legal opinion obtained by an Islamic Bank.
- (3) A netting agreement is not an eligible netting agreement if there is doubt about its enforceability.



**6.64. Legal opinion must cover transaction**

- (1) An Islamic Bank must ensure that a netted transaction is covered by an appropriate legal opinion.
- (2) In calculating the net sum due to or from a counterparty, an Islamic Bank must exclude netted transactions for which it has not obtained a satisfactory legal opinion applicable in the relevant jurisdiction. An excluded transaction must be reported on a gross basis.

**6.65. Conclusion about enforceability**

- (1) For rule 6.63 (1) (d), the legal opinion must conclude that, in the event of default, liquidation, bankruptcy or other similar circumstances of a party to the netting agreement, the Islamic bank's claims and obligations are limited to the net sum calculated under the netting agreement in accordance with the applicable law.
- (2) In particular, the legal opinion must conclude that, in the event of insolvency or external administration of a counterparty, a liquidator or administrator of the counterparty will not be able to claim a gross amount from an Islamic Bank while only being liable to pay a dividend in insolvency to an Islamic Bank (as separate money flows).
- (3) The AFSA expects the legal opinion to deal with the issue of which of the following laws applies to the netting:
  - (a) the law of the jurisdiction in which the counterparty is incorporated or formed (or, in the case of an individual, resides)
  - (b) if an overseas branch of the counterparty is involved—the law of the jurisdiction in which the branch is located
  - (c) the law that governs the individual transactions
  - (d) the law that governs any contract or agreement necessary to give effect to the netting.

**Guidance**

In some countries, there are provisions for the authorities to appoint an administrator to a troubled bank. Under statutory provisions applying in those countries, the appointment of an administrator might not constitute a ground for triggering a netting agreement. Such provisions do not prevent the recognition of an affected netting agreement if the agreement can still take effect if the bank under administration does not meet its obligations as they fall due.

**6.66. Requirements - legal opinion**

- (1) Before an Islamic Bank uses a legal opinion to support a netting agreement, an Islamic Bank:
  - (a) must ensure that the opinion is not subject to assumptions or qualifications that are unduly restrictive;
  - (b) must review the assumptions about the enforceability of the agreement and must ensure that they are specific, factual and adequately explained in the opinion; and
  - (c) must review and assess the assumptions, qualifications and omissions in the opinion to determine whether they give rise to any doubt about the enforceability of the agreement.



- (2) An Islamic Bank must have procedures to monitor legal developments and to ensure that its netting agreements continue to be enforceable. An Islamic Bank must update the legal opinions about the agreements, as necessary, to ensure that the agreements continue to be eligible.
- (3) An Islamic Bank may rely on a legal opinion obtained on a group basis by another member of the financial group of which it is a member if an Islamic Bank and the other member have satisfied themselves that the opinion covers a netting agreement to which an Islamic Bank is a counterparty.
- (4) An Islamic Bank must report a transaction on a gross basis if there is any doubt about, or any subsequent legal development affects, the enforceability of the agreement.

**6.67. Relying on general legal opinions**

- (1) An Islamic Bank may rely on a general legal opinion about the enforceability of netting agreements in a particular jurisdiction if an Islamic Bank is satisfied that the type of netting agreement is covered by the opinion.
- (2) An Islamic Bank must satisfy itself that the netting agreement with a counterparty and the general legal opinion are applicable to each transaction and product type undertaken with the counterparty, and in all jurisdictions where those transactions are originated.

**6.68. Netting of positions across books**

An Islamic Bank may net positions across its Banking and Trading Books only if:

- (a) the netted transactions are marked-to-market daily; and
- (b) any collateral used in the transactions satisfies the criteria for eligible collateral in the Banking Book.

**6.69. Monitoring and reporting of netting agreements**

- (1) If directed by the AFSA, an Islamic Bank must demonstrate that its netting policy is consistently implemented, and that its netting agreements continue to be enforceable.
- (2) An Islamic Bank must keep adequate records to support its use of netting agreements and to be able to report netted transactions on both gross and net bases.
- (3) An Islamic Bank must monitor its netting agreements and must report and manage:
  - (a) roll-off risks;
  - (b) exposures on a net basis; and
  - (c) termination risks;

for all the transactions included in a netting agreement.

**6.70. Collateral and guarantees in netting**

- (1) An Islamic Bank may take collateral and guarantees into account in calculating the risk-weight to be applied to the net sum under a netting agreement.
- (2) An Islamic Bank may assign a risk-weight based on collateral or a guarantee only if:





- (a) the collateral or guarantee has been accepted or is otherwise subject to an enforceable agreement; and
  - (b) the collateral or guarantee is available for all the individual transactions that make up the net sum of exposures calculated.
- (3) An Islamic Bank must ensure that provisions for applying collateral or guarantees to netted exposures under a netting agreement comply with the requirements for eligible collateral and guarantees in these rules.

#### **6.71. Provisioning**

- (1) Provisioning means setting aside an amount to cover expected losses on special mention credits, impaired credits and other problem assets, based on financing-loss probability. Provisioning is made before profit is earned.
- (2) Depending on the nature, scale and complexity of an Islamic Bank's business, and of the credit it provides, an Islamic Bank's provisioning policy must set out:
  - (a) the areas of its business to which the policy applies;
  - (b) whether an Islamic Bank uses different approaches to those areas, and the significant differences in approach;
  - (c) who is responsible for regularly monitoring its assets, to identify problem or potential problem assets, and the factors it takes into account in identifying them;
  - (d) the extent to which the value of any collateral or guarantees that an Islamic Bank holds affects the need for, or the level of, provisions;
  - (e) the basis on which an Islamic Bank makes its provisions, including the extent to which their levels are left to managerial judgement or to a committee;
  - (f) the methods, debt management systems or formulae used to set the levels of provisions and the factors that must be considered in deciding whether the provisions are adequate;
  - (g) the reports to enable an Islamic Bank's Governing Body and senior management to ensure that an Islamic Bank maintains adequate provisions;
  - (h) the procedures and responsibilities for arrears management and the recovery of exposures in arrears or exposures that have had provisions made against them;
  - (i) the procedures for writing off and writing back provisions; and
  - (j) the procedures for calculating and making provisions for contingent and other liabilities (such as contingent liabilities that have crystallised from acceptances, endorsements, guarantees, performance bonds, indemnities, irrevocable letters of credit and the confirmation of documentary credits).

#### **6.72. Making provisions**

- (1) An Islamic Bank must ensure that an Islamic Bank maintains provisions that, taken together, are prudent, reasonable and adequate to absorb financing losses, given the facts and circumstances. The losses covered must include losses incurred, losses



incurred but not yet reported, and losses estimated but not certain to arise, extending over the life of the individual credits that make up its credit portfolio.

- (2) An Islamic Bank must also ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions. An Islamic Bank must consider all the significant factors that affect the likelihood of collecting on the transactions that make up its financing portfolio and the estimated future credit losses on those transactions.
- (3) An Islamic Bank must make provisions that in total meet the requirements in table 6.17.

**Table 6.17 Provisioning requirements**

Item	Category	Provisioning requirement (% of the unsecured part of the credit)
1	performing	0
2	special mention	5
3	substandard	20
4	doubtful	50
5	loss	100

- (4) Provisions may be general (assessed collectively against the whole of a portfolio) or specific (assessed against individual financings), or both.
- (5) An Islamic Bank must take into account off-balance-sheet exposures in its categorisation of financings and in provisioning.

#### **Guidance**

No provisioning is necessary for any off-balance-sheet exposures that can be unilaterally cancelled by an Islamic Bank.

#### **6.73. Review of levels**

The levels of provisions and write-offs must be reviewed regularly to ensure that they are consistent with identified and estimated losses.

#### **Guidance**

- i) A review of a firm's write-offs can help identify whether an Islamic Bank's provisioning policy results in over-provisioning or under-provisioning.
- ii) The AFSA regularly assesses trends and concentrations in risk and risk build-up across financial entities in relation to problem assets. In making the assessment, the AFSA takes into account any observed concentration in the CRM techniques used by firms and the potential effect on the efficacy of those techniques in reducing loss. The authority would



consider the adequacy of provisions for a firm (and the industry in general) in the light of the assessment.

- iii) The AFSA might seek the opinion of external experts in assessing the adequacy of a firm's policies for grading and classifying its assets and the appropriateness and robustness of the levels of its provisions.

### **6.74. Prohibition on evergreening**

An Islamic Bank must not restructure, refinance or reclassify assets with a view to evergreen its financing exposures, leading to such exposures being classified in a higher category thereby circumventing the requirements on provisioning. In particular, impaired financing s must not be refinanced with the aim of classifying them as standard or special mention financings.

### **6.75. AFSA can reclassify assets**

- (1) The AFSA may at any time require an Islamic Bank to demonstrate that an Islamic Bank's classification of its assets, and its provisions, are adequate for prudential purposes.
- (2) The AFSA may require an Islamic Bank to reclassify its assets or increase the levels of its provisions if the AFSA considers that the asset classifications are inaccurate, or the provisions are inadequate, for prudential purposes.

#### **Guidance: Example**

If the AFSA considers that existing or anticipated deterioration in asset quality is of concern or if the provisions do not fully reflect expected losses, the AFSA may require an Islamic Bank to adjust its classifications of individual assets, increase its levels of provisions or capital and, if necessary, impose other remedial measures.

### **6.76. Reporting to Governing Body**

- (1) An Islamic bank's Governing Body must obtain timely information on the condition of an Islamic Bank's assets, including the classification of assets, the levels of provisions and problem assets.
- (2) The information must include summary results of the latest asset review, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected.

### **6.77. Transactions with related parties**

- (1) To guard against abuses in financing to related parties and to address conflicts of interest, this Part requires transactions with related parties to be at arm's length and subject to appropriate supervision and limits.
- (2) Related-party transactions must be interpreted broadly. Related party transactions include on-balance-sheet and off-balance-sheet financing exposures, service contracts, asset purchases and sales, construction contracts, lease agreements, borrowing and write-offs.

### **6.78. Concept of related parties**

- (1) The concept of parties being related to an Islamic Bank is used in these rules in relation to parties over which an Islamic Bank exercises control or parties that exercise control



over an Islamic Bank. The concept is primarily used in relation to the requirement that an Islamic Bank's transactions be at arm's length.

- (2) In contrast, the concept of parties being connected to one another (which is discussed with concentration risk in Chapter 9) is used in these rules to measure concentration risk and large exposures.
- (3) It is of course possible for connected counterparties to be related to the Islamic Bank holding the exposure concerned.
- (4) Related parties, of an Islamic Bank, includes:
  - (a) any other member of an Islamic Bank's corporate group;
  - (b) any individual who is able to exercise significant influence over an Islamic Bank;
  - (c) any affiliate of an Islamic Bank; and
  - (d) any entity that the AFSA directs an Islamic Bank to include.

### Guidance

Related party is wider than a firm's corporate group in that it includes individuals. Related parties include the Islamic Bank's subsidiaries and major stock holders; members of its Governing Body; its senior management and key employees.

### 6.79. Role of Governing Body—related parties

- (1) An Islamic bank's Governing Body must ensure that an Islamic Bank's policies relating to related-party transactions are complied with and that any exceptions are reported to the appropriate level of the senior management, and, if necessary, to the Governing Body.
- (2) The Governing Body must also ensure that an Islamic Bank's senior management monitors transactions with related parties, takes appropriate steps to control or mitigate the risks from such transactions and writes off exposures to related parties only in accordance with an Islamic Bank's policies.
- (3) The Governing Body must approve transactions with related parties, and the write-off of related-party exposures, if such transactions or write-off exceeds specified amounts or otherwise poses any special risk.

### 6.80. Policies—transactions with related parties

- (1) An Islamic bank's policy must establish:
  - (a) effective systems to identify, monitor and report individual and total exposures to, and transactions with, related parties;
  - (b) procedures to prevent a member of the Governing Body, a member of an Islamic Bank's senior management or any other person who stands to gain a benefit from a related-party transaction from being part of the process of granting and managing the transaction;
  - (c) well-defined criteria for writing-off exposures to related parties;
  - (d) prudent and appropriate limits to prevent or address conflicts of interest; and



- (e) procedures for tracking and reporting exceptions to, and deviations from, limits or policies.

**6.81. Transactions must be arm's length**

A transaction with a related party must not be undertaken on terms more favourable to the party than a corresponding transaction with a non-related party.

**Guidance**

Favourable terms could relate to credit assessment, tenor, fees, amortisation schedule and need for collateral. An exception for beneficial terms could be appropriate if it is part of an employee's remuneration package.

**6.82. Limits on financing to related parties**

An Islamic Bank must not enter into a transaction that would cause it to exceed the limits set out in table 6.18, without AFSA's written approval to do so.

**Table 6.18 Limits on Islamic Banks' exposure to related parties**

Item	Kind of Exposure	Limit (% of total assets)
1	exposures to a member of the Governing Body or senior management of an Islamic Bank, or a person connected to either of them	0.5
2	the total of exposures under item 1	3
3	exposures to a significant shareholder of an Islamic Bank (other than exposures to a shareholder that is an Islamic Bank or an equivalent entity regulated in a way comparable to an Islamic Bank)	2
4	the total of exposures under item 3	5
5	exposures to a related party or a party connected to the related party (other than exposures to an Islamic Bank or an equivalent entity regulated in a way comparable to an Islamic Bank)	2
6	the total of exposures under item 5	5

**6.83. Powers of the AFSA**

- (1) Despite anything in these rules, the AFSA may, in writing, set specific limits on an Islamic bank's exposures to a related party or to related parties in total.
- (2) The AFSA may direct such exposures to be deducted from Regulatory Capital when assessing capital adequacy or direct that such exposures be collateralised.



## 7. CONCENTRATION RISK AND LARGE EXPOSURES

### 7.1. General

This Chapter sets out the requirements for an Islamic Bank's policies to identify, measure, evaluate, manage and control or mitigate concentrations of risk. This Chapter also sets limits on an Islamic Bank's exposures to individual counterparties and connected counterparties.

### 7.2. Concept of connected parties

- (1) The concept of parties being connected to one another is used in these rules in relation to counterparties or issuers to which an Islamic Bank has exposures. Connected counterparties are the basis for the measurement of concentration risk and large exposures.
- (2) In contrast, the concept of parties being related to the Islamic Bank (which is discussed with Credit Risk in Chapter 6) is primarily used in relation to the requirement that an Islamic Bank's transactions be at arm's length.
- (3) It is of course possible for a firm's related parties to be connected counterparties (such as when an Islamic Bank has exposures to them).

### 7.3. Connected parties

- (1) A party is **connected** to another party if they are linked by:
  - (a) cross guarantees;
  - (b) common ownership;
  - (c) common management;
  - (d) one having the ability to exercise control over the other, whether direct or indirect;
  - (e) financial interdependency—that is, the financial soundness of one may affect the financial soundness of the other; or
  - (f) any combination of the factors mentioned in paragraphs (a) to (e).

#### Guidance

- i) Parties would be connected if the same persons significantly influence the Governing Body of each of them.
- ii) Parties would be connected if one of them has an exposure to the other that was not incurred for the clear commercial advantage of both of them and is not on arm's length terms.
- iii) Parties would be connected if they are so closely linked that:
  - a) the insolvency or default of one is likely to be associated with the insolvency or default of the other;
  - b) it would be prudent when assessing the financial condition or creditworthiness of one to consider that of the other; or



- c) there is, or is likely to be, a close relationship between their financial performance.
- iv) Parties would be connected if an Islamic Bank has exposures to them and any loss to an Islamic Bank on any of the exposures to one of the parties is likely to be associated with a loss to an Islamic Bank with respect to at least 1 exposure to each of the others.
- v) A counterparty may be **connected** to another counterparty by other linkages that, in the Islamic Bank's assessment, connect the counterparties as constituting a single risk.
- vi) A **connected party** can be an individual or other entity.
- vii) Two or more individuals or legal persons would constitute a single risk if they are so connected that, if one of them were to experience financial problems, the other or others would be likely to encounter repayment difficulties.
- viii) Connected counterparties should be identified and the procedures to manage the combined Credit Risk considered. An Islamic Bank may need to monitor and report the gross exposure to connected counterparties against combined limits in addition to monitoring the exposure to each counterparty.

### 7.4. Role of Governing Body—concentration risk

- (1) An Islamic bank's Governing Body must ensure that an Islamic Bank's concentration risk management policy gives an Islamic Bank a comprehensive firm-wide view of the significant sources of concentration risk (including on-balance-sheet exposures, off-balance-sheet exposures and exposures from contingent liabilities).
- (2) The Governing Body must also ensure that an Islamic Bank's senior management monitors the limits set in this Chapter and that those limits are not exceeded on a solo or consolidated basis.

### 7.5. Concentration risk

Concentration risk to an Islamic Bank arises if an Islamic Bank is exposed to 1 counterparty, or to 2 or more counterparties that are not truly independent of each other, and the total of the exposures to the counterparty or counterparties is large enough to endanger an Islamic Bank's liquidity or solvency.

#### Guidance

Significant sources of concentration risk include:

- i) concentration of exposures to a single counterparty or connected counterparties;
- ii) concentration of exposures to counterparties in the same industry, sector, region or country; and
- iii) concentration of exposures to counterparties whose financial performance depends on the same activity or commodity.

A concentration of exposures would also arise if a firm accepts collateral or credit protection provided by a single provider (because an Islamic Bank is exposed to the provider).



**7.6. Policies—concentration risk sources and limits**

- (1) An Islamic bank's concentration risk policy must set limits for acceptable concentrations of risk, consistent with an Islamic Bank's risk tolerance, risk profile and Capital. The limits must be made known to, and must be understood by, all relevant staff.
- (2) The policy must require that:
  - (a) an Islamic Bank's information systems identify exposures creating risk concentrations and large exposures to single counterparties or connected counterparties, aggregate those exposures and facilitate their management; and
  - (b) all significant such concentrations and exposures are reviewed regularly and reported to an Islamic Bank's Governing Body or senior management.

**Guidance**

An Islamic bank's policies should be flexible to help an Islamic Bank to identify risk concentrations. To achieve this, the systems should be capable of analysing an Islamic Bank's credit portfolio by:

- (a) size of exposure;
- (b) exposure to connected counterparties;
- (c) product;
- (d) geography;
- (e) industry or sector (for example, manufacturing and industrial);
- (f) account performance;
- (g) internal Credit Risk assessment;
- (h) funding;
- (i) outstandings versus commitments;
- (j) types and coverage of collateral.

**7.7. Relation to stress-testing**

When carrying out stress-testing or review of stress scenarios, an Islamic Bank must take into account significant risk concentrations and large exposures, and the effects of changes in market conditions and risk factors on them.

**7.8. Large Exposures**

- (1) Large Exposure means a gross exposure to a counterparty or connected counterparties that is 10% or more of an Islamic bank's Regulatory Capital.
- (2) In this rule, gross exposure to a counterparty or connected counterparties is the total of the following exposures:
  - (a) on-balance-sheet and off-balance-sheet exposures;





- (b) debt securities held by an Islamic Bank;
  - (c) equity exposures.
- (3) In calculating the gross exposure, include:
  - (a) the outstanding balances of all financings and advances;
  - (b) holdings of debt or equity securities;
  - (c) unused advised off-balance-sheet commitments, whether revocable or irrevocable; and
  - (d) the Credit Equivalent Amounts of all market-related transactions.
- (4) However, in calculating the gross exposure, do not include:
  - (a) claims, equity investments and other exposures deducted from an Islamic Bank's capital;
  - (b) exposures to the extent that they are secured by cash collateral, if the criteria applicable to transactions collateralised by cash are satisfied;
  - (c) exposures to the extent that they are guaranteed by (or secured against securities issued by) the AIFC, the National Bank of Kazakhstan, or another state or central bank that has a zero per cent risk-weight;
  - (d) exposures arising in the course of settlement of market-related contracts; and
  - (e) exposures to the extent that they have been written off or specifically provided for.

## **7.9. Policies —Large Exposures**

An Islamic bank's Large Exposure policy must include:

- (a) exposure limits, commensurate with an Islamic Bank's risk tolerance, risk profile and capital, for:
  - (i) categories of counterparties (for example, sovereigns, other authorised firms and other financial entities, corporate and individual borrowers);
  - (ii) connected counterparties;
  - (iii) particular industries or sectors;
  - (iv) particular countries; and
  - (v) asset classes (for example, property holdings);
- (b) the circumstances in which the exposure limits may be exceeded;
- (c) the procedures for approving exceptions to, and deviations from, exposure limits or policies; and
- (d) the procedures for identifying, measuring, managing and reporting large exposures.



**7.10. Limits on exposures—general**

- (1) An Islamic Bank must not become exposed without limit to a single counterparty. An Islamic Bank must not give a general guarantee of the obligations of a counterparty.
- (2) An Islamic Bank may apply to the AFSA for approval for a proposed exposure in excess of the limits set out in this Chapter. An approval will be granted only in exceptional circumstances and only after an Islamic Bank satisfies the AFSA that the proposed exposure does not expose an Islamic Bank to excessive risk.
- (3) The AFSA may impose a higher Regulatory Capital ratio on an Islamic Bank to compensate for the additional risk associated with the proposed exposure.

**7.11. Limits on exposure—Islamic Bank**

- (1) An Islamic Bank must not have an exposure to a counterparty or to connected counterparties that exceeds any 1 of the following percentages of its Regulatory Capital:
  - (a) 25% if financed by either its Regulatory Capital or funds raised through UPSIAs;
  - (b) 40% if financed by the total of its Regulatory Capital and funds raised through UPSIAs.
- (2) The sum of an Islamic bank's non-exempt Large Exposures must not exceed 800% of its Regulatory Capital for exposures financed by its on-balance sheet sources of funding and Regulatory Capital.
- (3) The Islamic Bank must monitor and control its exposures financed by its on-balance sheet sources of funding and Regulatory Capital on a daily basis to ensure that they remain within the concentration risk limits.

**Guidance**

- (i) This rule sets specific large exposure limits for assets financed by *Shari'ah*-compliant sources. The AFSA uses these limits to provide constraints on the amount of concentration risk to which an Islamic Bank is exposed in respect of its holdings.
- (ii) An Islamic Bank has a large exposure if its fund holders' or account holders' financing exposure to a single counterparty or issuer, or connected counterparties or issuers, is large in relation to an Islamic Bank's regulatory Capital. If exposure to a counterparty or issuer is large, the holders risk a large loss should the counterparty or issuer default.

**7.12. Obligation to measure**

- (1) An Islamic Bank must measure, classify and make provision for each large exposure individually.
- (2) An Islamic Bank must immediately notify the AFSA if an Islamic Bank is concerned that risk concentrations or large exposures might significantly affect its capital adequacy. The notice must describe an Islamic Bank's proposed measures to address its concerns.

**7.13. Powers of AFSA**

- (1) If the AFSA considers it necessary or desirable to do so in the interest of effective supervision of an Islamic Bank, the AFSA may direct an Islamic Bank to treat a party as connected to another party.



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- (2) Despite anything in these rules, the AFSA may, in writing, set specific limits on an Islamic bank's exposures to particular counterparties, groups of counterparties, industries, sectors, regions, countries or asset classes on a case-by-case basis.
- (3) If an Islamic Bank has 1 or more large exposures (excluding exposures to sovereigns and central banks) or if, in the AFSA's opinion, an Islamic Bank is exposed to a significant level of risk concentration, the AFSA may impose a higher capital ratio on an Islamic Bank.
- (4) In considering whether to increase an Islamic Bank's capital ratio, the AFSA will take into account:
  - (a) whether the increased capital ratio would be consistent with an Islamic Bank's concentration risk and large exposure policies;
  - (b) the number of exposures, and the size and nature of each; and
  - (c) the nature, scale and complexity of an Islamic Bank's business and the experience of its Governing Body and senior management.
- (5) The AFSA may also direct an Islamic Bank to take measures to reduce its level of risk concentration.



## **8. MARKET RISK**

### **8.1. General**

- (i) This Chapter sets out the requirements for an Islamic bank's Market Risk management policy to identify, measure, evaluate, manage and control or mitigate Market Risk. This Chapter also sets out how to calculate an Islamic Bank's Market Risk Capital Requirement.
- (ii) An Islamic Bank that operates in a market incurs risks from potential movements in market prices.
- (iii) In calculating its Capital Requirement, an Islamic Bank must take into account unexpected losses that may arise from the Market Risk exposures it faces.
- (iv) In determining the value of an asset or liability, an Islamic Bank must also make appropriate adjustments for uncertainties arising from Market Risk.

### **8.2. Role of Governing Body—Market Risk**

An Islamic bank's Governing Body must ensure that its Market Risk management policy gives an Islamic Bank a comprehensive firm-wide view of its Market Risk exposure and takes into account the risk of a significant deterioration in market liquidity.

### **8.3. Relation to stress-testing**

When carrying out stress-testing or review of stress scenarios, an Islamic Bank must take into account Market Risk exposures.

### **8.4. Requirements—Capital and management of Market Risk**

- (1) An Islamic Bank must have adequate capital to cover Market Risk exposures in its Banking and Trading Books.
- (2) An Islamic Bank must also have robust Market Risk measurement and Market Risk management tools, systems and controls.

### **8.5. Trading Book**

- (1) An Islamic bank's trading book consists of the positions held by an Islamic Bank (whether on-balance-sheet or off-balance-sheet) that must be included in the book in accordance with these rules. Other positions held by an Islamic Bank must be included in its Banking Book.
- (2) An Islamic Bank must have a Trading Book if:
  - (a) it has positions that must be included in the Trading Book; and
  - (b) the total value of the positions described in paragraph (a) has exceeded 5% of the total of an Islamic Bank's on-balance-sheet and off-balance-sheet positions at any time in the previous 12 months.
- (3) An Islamic Bank must include, in the Trading Book, trading positions and exposures of the following kinds:
  - (a) a position taken to hedge an exposure in the Trading Book, using *Shari'ah*-compliant hedging instruments;
  - (b) a principal broking position in a financial instrument, commodity or commodity *Shari'ah*-compliant hedging instrument;



- (c) an exposure from a purchase agreement, or securities or commodities financing, that is based on a position in a security or commodity included in the Trading Book;
  - (d) an exposure from a promise to is based on a position in a security or commodity included in the Trading Book;
  - (e) an exposure from an unsettled transaction, a free delivery or an OTC *Shari'ah*-compliant hedging instrument;
  - (f) an exposure in the form of a fee, commission, profit, dividend or margin on an exchange-traded *Shari'ah*-compliant hedging instrument directly related to a position included in the Trading Book.
- (4) An Islamic Bank must also include in its Trading Book:
- (a) total-rate-of-return swaps (except those that have been transacted to hedge a Banking Book financing exposure); and
  - (b) open short positions in *Shari'ah*-compliant hedging instruments.
- (5) An Islamic Bank must not include in its Trading Book:
- (a) positions held for liquidity management; and
  - (b) financings (unless they are used to hedge a position or transaction in the Trading Book).
- (6) **Trading position**, of an Islamic Bank, means a position that is held:
- (a) for short-term resale;
  - (b) with the intent of benefiting from actual or expected short-term price movements; or
  - (c) to lock in arbitrage profits.

#### Guidance

Whenever an Islamic Bank acts as principal (even in the course of an activity normally described as 'broking' or 'customer business'), the resulting positions should be included in the Trading Book. This applies even if the nature of the business means that the only risks being incurred by an Islamic Bank are counterparty risks (that is, no Market Risk Capital Requirements apply).

#### 8.6. No switching of instruments between books

- (1) An Islamic Bank must not switch an instrument between its Trading Book and Banking Book, unless the AFSA has, in writing, allowed an Islamic Bank to do so. The AFSA may approve a switch subject to 1 or more conditions.
- (2) An Islamic Bank must not benefit from any lower Regulatory Capital requirement resulting from a switch approved by the AFSA.

#### Guidance

The AFSA will grant approval to switch exposures or positions between Banking and Trading Books only in extraordinary cases and in such cases, the Islamic Bank will be required to publicly disclose the switch.



**8.7. Market Risk management policy**

- (1) An Islamic bank's Market Risk management policy must establish:
  - (a) effective systems for the accurate and timely identification, measurement, evaluation, management and control or mitigation of Market Risk, and reporting to an Islamic Bank's Governing Body and senior management;
  - (b) prudent and appropriate Market Risk limits that are consistent with an Islamic Bank's risk tolerance, risk profile and Capital, and with the management's ability to manage;
  - (c) who is responsible for identifying, measuring and reporting Market Risk;
  - (d) procedures for tracking and reporting exceptions to, and deviations from, limits or policies; and
  - (e) procedures for including positions and exposures in the Trading Book.
- (2) The policy must ensure that all of an Islamic Bank's transactions are identified and recorded in a timely way and that their valuations are consistent and prudent.

**8.8. Trading Book policies**

- (1) An Islamic Bank that is required to have a Trading Book must have clearly defined policies for keeping the book up-to-date and the positions and exposures accurate.
- (2) In particular, an Islamic Bank must have policies on:
  - (a) what to include, or not include, in the Trading Book;
  - (b) managing and reporting trading positions;
  - (c) valuing positions, including:
    - (i) clear definitions of the responsibilities of staff involved in the valuation;
    - (ii) sources of market information, and review of their reliability;
    - (iii) frequency of independent valuations;
    - (iv) timing of closing prices;
    - (v) procedures for adjusting valuations between periods;
    - (vi) ad-hoc verification procedures; and
    - (vii) reporting lines for the valuation function that are independent of the function that gave rise to the position.
- (3) The policies must be approved by an Islamic Bank's Governing Body, and an Islamic Bank must be able to demonstrate compliance with them if directed by the AFSA.
- (4) An Islamic Bank must also have adequate policies:



- (a) to monitor compliance with the policies and distinguish consistently between trading activities and banking activities;
- (b) to deal with legal, regulatory or operational restrictions on immediate liquidation of exposures; and
- (c) to monitor the size of its Trading Book.

#### 8.9. Measurement of Market Risk - Standard method

- (1) An Islamic Bank must use the standard method for measuring Market Risk unless the AFSA has approved the use of an internal model for the same purpose. The standard method comprises a range of approaches that a firm may use to calculate Market Risk Capital Requirement from its trading activities.
- (2) In the standard method, Market Risk Capital Requirement is the sum of the capital charges for:
  - (a) foreign exchange risk in the Trading Book and Banking Book;
  - (b) options risk in the Trading Book and Banking Book;
  - (c) commodities risk in the Trading Book and Banking Book;
  - (d) inventory risk in the Trading Book and Banking Book;
  - (e) traded equity position risk; and
  - (f) traded profit rate risk on *sukuk* and other *Shari'ah*-compliant debt securities and profit-rate-related instruments.

#### 8.10. Valuing positions—mark-to-market

- (1) An Islamic Bank must use the mark-to-market method to value its positions and exposures if there is a market to mark the positions and exposures to. Mark-to-market means a valuation that is based on current market value.
- (2) The AFSA would expect an Islamic Bank to mark-to-market listed securities since there is a market with observable and reliable prices for such securities.
- (3) A position that is marked-to-market must be revalued daily, based on independently sourced current market prices.

#### Guidance

- (i) Because of the less liquid nature of many *sukuk* and equity positions held by an Islamic Bank, it is important for an Islamic Bank to have prudent valuation practices.
- (ii) An Islamic Bank should mark-to-market as much as possible. It should use the prudent side of a bid or offer unless an Islamic Bank is a significant market maker that can close at mid-market.
- (iii) When estimating fair value, an Islamic Bank should maximise the use of relevant observable inputs and avoid the use of unobservable inputs.



#### 8.11. Valuing positions—mark-to-model

- (1) If it is not possible to mark-to-market (for example, in the case of unlisted securities or where the market is inactive), an Islamic Bank may use the mark-to-model method to value its positions and exposures. Mark-to-model means a valuation that has to be benchmarked, extrapolated or otherwise calculated from a market input.
- (2) An Islamic Bank must be able to demonstrate that its marking-to-model is prudent.

##### Guidance

An Islamic Bank should be extra conservative when marking-to-model. The AFSA will take into account the following in deciding if an Islamic Bank's model is prudent:

- (a) whether senior management is aware of the positions and exposures that are marked to model and whether it understands the uncertainty this might create in reporting the risk or performance of the business
- (b) the extent to which market inputs are sourced from market prices
- (c) the appropriateness of the assumptions used by an Islamic Bank
- (d) the availability of generally accepted valuation methods for particular products
- (e) who developed the model
- (f) whether an Islamic Bank holds a secure copy of the model
- (g) the existence of formal control procedures for changing the model
- (h) how often the model is used to check valuations
- (i) how aware is an Islamic Bank's risk management function of the weaknesses of the model and how those weaknesses are reflected in the valuation output
- (j) the results of comparisons between actual close out values and model outputs
- (k) an Islamic Bank's procedures for reviewing the model.

#### 8.12. Independent price verification

An Islamic Bank must independently verify market prices and model inputs, to check that those prices and inputs are accurate. The verification must be done at least once a month.

##### Guidance

- (i) Independent price verification is different from daily mark-to-market. The object of the verification is to regularly check the accuracy of market prices or model inputs and, thereby, eliminate inaccurate daily marks. The verification should be carried out by a unit independent of whoever marked the positions or exposures.
- (ii) The independent marking in the verification process should reveal any error or bias in pricing. It entails a higher standard of accuracy in that the market prices or model inputs are used to determine profit and loss figures, whereas daily marks are used primarily for management reporting in between reporting dates.





### 8.13. Valuation adjustments

- (1) An Islamic Bank must consider making adjustments for positions that cannot be prudently valued (such as those that have become concentrated, less liquid or stale). For example, valuation adjustment would be appropriate if pricing sources are more subjective (such as when there is only one available broker quote).
- (2) An Islamic Bank must establish and maintain procedures for considering valuation adjustments. This rule applies whether:
  - (a) an Islamic Bank uses the mark-to-market or mark-to-model method; and
  - (b) whether the valuation is done by an Islamic Bank itself or a third party.
- (3) An Islamic Bank must consider the following valuation adjustments:
  - (a) unearned profit;
  - (b) close-out costs;
  - (c) Operational Risks;
  - (d) early termination;
  - (e) investing and funding costs;
  - (f) future administrative costs;
  - (g) model risk, if relevant;
  - (h) any other adjustment that an Islamic Bank considers appropriate.

### 8.14. Foreign exchange risk

- (1) In measuring its Market Risk, an Islamic Bank must include the risk of holding or taking positions in foreign currencies, gold and silver (**exchange risk**). Foreign exchange risk may arise from an Islamic Bank's trading in the foreign exchange market and other markets; it may also arise from non-trading activities that are denominated in a foreign currency.
- (2) If an Islamic Bank is exposed to profit rate risk on positions in foreign currencies, gold and silver, an Islamic Bank must include the relevant profit rate positions in the calculation of profit rate risk in the Trading Book.
- (3) Silver and gold are treated under *Shari'ah* as foreign exchange positions (rather than as commodity positions).
- (4) If foreign currency is to be received or delivered under a binding unilateral promise, an Islamic Bank must report any profit rate exposure from the other leg of the contract in accordance with Rule 8.43 (profit rate risk in the Trading Book).
- (5) If gold or silver is to be received or delivered under a binding unilateral promise, an Islamic Bank must report any foreign currency or profit rate exposure from the other leg of the contract in accordance with this Rule or Rule 8.43, as the case requires.



**8.15. What to include in foreign exchange risk**

- (1) In calculating the capital charge for foreign exchange risk, an Islamic Bank must include in its exposure to each foreign currency:
  - (a) the net spot position (that is, assets minus liabilities denominated in the currency, including accrued profit and other accrued income and accrued expenses);
  - (b) the net position of binding unilateral promises by an Islamic Bank to buy or sell currencies on a specified future date (that are not included in the spot position);

**Examples of amounts to be received or paid**

- (i) the principal on currency swaps not included in the spot position
  - (ii) profit from swaps and other profit rate transactions.
  - (c) irrevocable guarantees (and similar instruments) that are certain to be called and likely to be irrecoverable; and
  - (d) any other items representing an exposure to risk in foreign currencies (for example a specific provision held in the currency in question where the underlying asset is held in a different currency).
- (2) An Islamic Bank may also include in its currency exposure any net future income or expenses that are not yet accrued but already fully hedged. If an Islamic Bank includes such income or expenses, it must do so consistently and must not select only expected future flows that reduce its position.
- (3) If an Islamic Bank has deliberately taken a position to partly or totally protect itself against the adverse effect of a change in an exchange rate on its capital adequacy ratio, it may exclude the position from its currency exposure insofar as it relates to that hedge, if:
  - (a) the position is of a structural and non-trading nature;
  - (b) the structural position does no more than protect an Islamic Bank's capital adequacy ratio;
  - (c) the position cannot be traded for speculative or profit-making purposes; and
  - (d) the exclusion of the position is done consistently, with the treatment of the hedge remaining the same for the life of the assets or other items.
- (4) A **structural position** includes:
  - (a) a position arising from an instrument that satisfies the criteria for inclusion as capital under Chapter 4 of this Rules;
  - (b) a position in relation to a net investment in a self-sustaining subsidiary, the accounting consequence of which is to reduce or eliminate what would otherwise be a movement in the foreign currency translation reserve; and
  - (c) an investment in an overseas Subsidiary or other entity in the same corporate group as an Islamic Bank that, under these rules, is deducted from an Islamic Bank's capital for capital adequacy purposes.



- (5) An Islamic Bank must also include any currency exposures arising from equity, commodity and profit rate positions.

#### 8.16. Foreign exchange risk on consolidated basis

- (1) If an Islamic Bank is assessing its foreign exchange risk on a consolidated basis and it is technically impractical for a marginal operation to include the currency positions of an overseas branch or Subsidiary of an Islamic Bank, the internal limit in each currency applied to the overseas branch or Subsidiary may be used as a proxy for the positions. Marginal operation, in relation to a firm, is an operation of an Islamic Bank that accounts for less than 5% of an Islamic Bank's total currency positions.
- (2) The absolute values of the limits must be added to the net open position in each currency, but only if the actual positions are adequately monitored against those internal limits.

#### 8.17. Capital charge—foreign exchange risk

- (1) For an Islamic Bank that does not write options, **net open position in a foreign currency** is the sum of:
- (a) an Islamic Bank's currency exposures under Rule 8.15 for the currency; and
  - (b) the value of the options and their associated underlying assets measured using the simplified approach.
- (2) For an Islamic Bank that writes options, net open position in a foreign currency is the sum of:
- (a) an Islamic Bank's currency exposures under Rule 8.15 for the currency; and
  - (b) either:
    - (i) the net delta-based equivalent of an Islamic Bank's total book of foreign currency options (with separately calculated capital charges for gamma risk and vega risk under Delta-plus method); or
    - (ii) the value of the options and their associated underlying assets under the delta-plus method under Delta-plus method.
- (3) An Islamic Bank must calculate its **overall foreign currency net open position** by:
- (a) calculating the net open position in each foreign currency;
  - (b) converting the nominal amount (or net present value) of each such net position into US Dollar at the current spot market exchange rate;
  - (c) adding all short net positions and adding all long net positions calculated under paragraphs (a) and (b); and
  - (d) selecting the greater of the absolute values of the 2 sums in paragraph (c).
- (4) An Islamic Bank must then calculate its **net position in gold and silver** by:
- (a) valuing all gold and silver positions using the US dollar current spot price (regardless of maturity);



- (b) offsetting long and short positions; and
  - (c) converting the absolute value of the resulting net position into US Dollar.
- (5) To convert the net position in gold and silver into US Dollar, an Islamic Bank must state the position (spot plus forward) in a standard unit of measurement and then convert the net position at the current spot market exchange rate.
- (6) The capital charge for foreign exchange risk of an Islamic Bank is the sum of:
- (a) 8% of an Islamic Bank's overall foreign currency net open position in each of the foreign currencies it holds; and
  - (b) 8% of its net position in gold and silver.

#### 8.18. Valuing positions—binding unilateral promises

An Islamic Bank must value net positions of binding unilateral promises in foreign exchange transactions, gold and silver at the current spot market exchange rates.

#### 8.19. Options risk

In measuring its Market Risk, an Islamic Bank must include the risk of holding or taking positions in options contracts (**options risk**).

#### 8.20. Measuring options risk

- (1) An Islamic Bank that does not write options must use the simplified approach.
- (2) An Islamic Bank that writes options must use the delta-plus method.

#### Simplified approach

#### 8.21. Using simplified approach

An Islamic Bank that does not write options must calculate capital charges in accordance with:

- (a) Rule 8.22 for a position that is a 'long cash and long put' or 'short cash and long call' position; or
- (b) Rule 8.23 for a position that is a 'long put' or 'long call' position.

#### Guidance

In the simplified approach, the position in the option and the associated underlying asset (cash or forward) is not subject to the mark-to-market method. Instead, each position is carved-out and is subject to a separately calculated capital charge for specific risk and general risk.

#### 8.22. Capital charges—'long cash and long put' or 'short cash and long call'

- (1) For a position that is 'long cash and long put' or 'short cash and long call', the capital charge is calculated by multiplying the market value of the underlying security by the sum of the specific and general risk capital charges for the underlying, and then subtracting the amount by which the option is in-the-money (bounded at zero).
- (2) In the simplified approach, the capital charge is:



- (a) 8% for options on currency; and
  - (b) 15% for options on commodities.
- (3) For options with a residual maturity of less than 6 months, an Islamic Bank must use the forward price (instead of the spot price) if it is able to do so.
- (4) For options with a residual maturity of more than 6 months, an Islamic Bank must compare the strike price with the forward price (instead of the current price). If an Islamic Bank is unable to do this, it must take the in-the-money amount to be zero.

#### **Guidance**

- i) In cases (such as foreign exchange transactions) where it is unclear which side is the underlying security, the underlying should be taken to be the asset that would be received if the option were exercised. In addition, the nominal value should be used for items if the market value of the underlying instrument could be zero (such as in caps, floors and swaptions).
- ii) Some options have no specific risk (such as those having a profit rate, currency or commodity as the underlying security); other options on profit-rate-related instruments and options on equities and stock indices, however, would have specific risk.

#### **8.23. Capital charges—‘long put’ or ‘long call’**

- (1) For a position that is ‘long put’ or ‘long call’, the capital charge is the lesser of:
  - (a) the market value of the underlying security multiplied by the sum of the specific and general risk capital charges for the underlying; and
  - (b) the market value of the option.
- (2) In respect of (1)(b) above, the book value of the option may be used instead of the market value if the position is not included in the Trading Book (for example, options on particular foreign exchange or commodities positions).

#### **Delta-plus method**

#### **8.24. Using delta-plus method**

- (1) An Islamic Bank that writes options must calculate specific risk capital charges separately by multiplying the delta-equivalent value of each option by the risk-weight applicable under equity position risk and profit rate risk in the Trading Book.
- (2) In calculating general risk capital charge, an Islamic Bank must enter delta-weighted positions with a debt security or profit rate as the underlying into the profit rate time bands in table 8.50 A by using a two-legged approach. Under this approach, there is 1 entry at the time the underlying contract takes effect and a second entry at the time the underlying contract matures.
- (3) For an option with a debt security as the underlying, an Islamic Bank must apply a specific risk capital charge to the delta-weighted position based on the issuer’s rating and in accordance with the rules on measuring profit rate risk – Rule 8.43



**8.25. Relation to mark-to-market method**

- (1) An Islamic Bank that writes options must include delta-weighted option positions in measuring its Market Risk.
- (2) An Islamic Bank must report such an option as a position equal to the sum of the market values of the underlying multiplied by the sum of the absolute values of the deltas. Because delta does not cover all risks associated with option positions, an Islamic Bank must calculate gamma and vega in calculating the Regulatory Capital charge.
- (3) An Islamic Bank must calculate delta, gamma and vega using the pricing model used by a recognised exchange, or a proprietary options pricing model approved, in writing, by the AFSA.

**8.26. Capital charges—options**

- (1) The capital charge for an option with equities as the underlying must be based on the delta-weighted positions included in the measurement of specific and general risks in accordance with Rules for Inventory risk (equity position risk).
- (2) An Islamic Bank that writes options must calculate the capital charge for options on foreign exchange and gold and silver positions in accordance with rules for foreign exchange risk. For delta risk, the net delta-based equivalent of the foreign currency, gold and silver options must be included in the measurement of the exposure for the respective currency, gold or silver position.
- (3) The capital charge for an option on commodities must be based on the charge calculated using the simplified approach in Rule 8.21.

**8.27. Gamma Capital charges**

- (1) An Islamic Bank that writes options must calculate the capital charge for gamma risk (**gamma capital charge**) for each option position separately.
- (2) To calculate gamma capital charge, calculate the gamma impact of each option in accordance with the following formula:

$$\text{Gamma impact} = \frac{1}{2} \times \text{gamma} \times VU^2$$

where:

**VU** is:

- (a) for a profit rate option:
  - (i) if the option has a bond as the underlying—the market value of the underlying multiplied by the risk factor applicable under column 3 of table 8.50 A; or
  - (ii) if the option has a profit rate as the underlying—the market value of the underlying multiplied by the assumed changes in yield in column 4 of table 8.50 A;
- (b) for options on equities and stock indices—the market value of the underlying multiplied by 8%;



- (c) for options on foreign exchange, gold and silver—the market value of the underlying multiplied by 8%; or
  - (d) for an option on commodities—the market value of the underlying multiplied by 15%.
- (3) In calculating the gamma impact for an option mentioned in the definition of VU, an Islamic Bank must treat as the same underlying:
  - (a) for profit rates—each time band in column 2 of table 8.50 A (with each position allocated to separate maturity ladders);
  - (b) for equities and stock indices—each recognised exchange;
  - (c) for foreign currencies, gold and silver—each currency pair, gold and silver; and
  - (d) for commodities—each individual commodity of a kind described in Rule 8.29.
- (4) Each option on the same underlying described in sub-rules (2) and (3) will have a gamma impact that is positive or negative. An Islamic Bank must add the individual gamma impacts, resulting in a net gamma impact for each underlying that is either positive or negative.
- (5) To calculate an Islamic Bank's total gamma capital charge, exclude gamma impacts that are positive. The **total gamma capital charge** is the sum of the absolute values of the net negative gamma impacts.

#### 8.28. Vega capital charges

- (1) An Islamic Bank that writes options must calculate the capital charge for vega risk (**vega capital charge**) for each option position separately.
- (2) To calculate vega capital charge, an Islamic Bank must multiply the vega for each option mentioned in the definition of VU in Rule 8.27 (2) by a 25% proportional shift in the option's current volatility. The results must then be summed across each underlying.
- (3) The **total vega Capital charge** is the sum of the absolute values of the vega capital charges across each underlying.

#### 8.29. Commodities risk and inventory risk

- (1) In measuring its Market Risk, an Islamic Bank must include the risk of holding or taking positions in commodities and commodities options (commodities risk).
- (2) Commodities means physical or energy products that may be traded. Commodities include precious metals (other than gold and silver), base metals, agricultural products, minerals, oil, gas and electricity.
- (3) If an Islamic Bank is exposed to foreign exchange or profit rate risk from funding commodities positions, an Islamic Bank must include the relevant positions in the measurement of foreign exchange risk and profit rate risk in the Trading Book—see Rules 8.17 and 8.43, respectively.
- (4) Unlike Basel II, silver and gold are treated under *Shari'ah* as foreign exchange positions (rather than as commodity positions). In Basel II, only gold is treated in that way.





- (5) If a commodity is to be received or delivered under a binding unilateral promise, an Islamic Bank must report any foreign currency, equity or profit rate exposure from the other leg of the contract in accordance with Rules under Inventory risk, as the case requires.

### 8.30. Measuring commodities risk

- (1) An Islamic Bank must use the simplified approach to measure commodities risk.
- (2) To calculate open positions using this approach, an Islamic Bank may report short and long positions in each commodity on a net basis. Positions are reported on a net basis by offsetting them against each other in accordance with sub-rule (3).
- (3) Positions in the same commodity may be offset. Positions in different commodities must not be offset unless:
  - (a) the positions are deliverable against each other; or
  - (b) the positions are in commodities which are close substitutes for each other and a minimum correlation between price movements of 0.9 can be clearly established over at least the preceding year.
- (4) An Islamic Bank must not use the correlation-based offsetting mentioned in paragraph (b) unless the AFSA has, in writing, allowed an Islamic Bank to use it.

### 8.31. Measuring net positions

An Islamic Bank must first state each commodity position (spot plus forward) in terms of the standard unit of measurement for the commodity (such as barrels, kilos or grams). An Islamic Bank must then convert the net position in each commodity into US Dollar at the current spot market exchange rates.

### 8.32. What to include in commodities risk

- (1) In calculating the capital charge for commodities risk, an Islamic Bank must include commodity *Shari'ah*-compliant hedging instruments and off-balance-sheet positions that are affected by changes in commodity prices (such as commodity swaps). An Islamic Bank must include commodities risk arising from *salam* contracts.
- (2) Options on commodities for which the options risk is measured using the delta-plus method must also be included (with their underlying assets). Options for which the options risk is measured using the simplified approach must be excluded.
- (3) An Islamic Bank must convert commodity *Shari'ah*-compliant hedging instruments into notional commodities positions and assign them to maturities under rule 8.33.

### 8.33. Assigning notional positions to maturities

Binding unilateral promises relating to a particular commodity must be included in the measurement of commodities risk as notional amounts in terms of the standard unit of measurement multiplied by the spot price of the commodity.

### 8.34. Capital charges—simplified approach

- (1) The capital charge for commodities risk of an Islamic Bank is the sum of:





- (a) 15% on an Islamic Bank's overall net position, long or short, in each commodity; and
  - (b) 3% on an Islamic Bank's gross position in each commodity.
- (2) **Gross position**, of a firm in a commodity, is the sum of the absolute values of all short positions and all long positions of an Islamic Bank, regardless of maturity.
- (3) An Islamic Bank must use the current spot price to calculate its gross position in commodity *Shari'ah*-compliant hedging instruments.

#### Inventory risk

##### 8.35. Relation to Market Risk

In measuring its Market Risk, an Islamic Bank must include the risk of holding assets in inventory with a view to reselling them under a *murabahah* contract or for leasing them under an *ijarah* contract (**inventory risk**).

##### 8.36. Measuring inventory risk

- (1) An Islamic Bank must use the simplified approach to measure inventory risk.
- (2) The capital charge for inventory risk of an Islamic Bank is 15% of the value of the assets held by an Islamic Bank in inventory with a view to resale or lease.

##### 8.37. Equity position risk

- (1) In measuring its Market Risk, an Islamic Bank must include the risk of holding or taking positions in equities (**equity position risk**).
- (2) If equities are to be received or delivered under a binding unilateral promise, an Islamic Bank must report any foreign currency or profit rate exposure from the other leg of the contract in accordance with Rules for currency exposures or the Rules addressing profit rate exposures, as the case requires.
- (3) If an Islamic Bank is exposed to profit rate risk on equity positions, an Islamic Bank must include the relevant profit rate positions in the calculation of profit rate risk in the Trading Book.

##### 8.38. Measuring equity position risk

- (1) The measurement of equity position risk in the Trading Book applies to short and long positions in all instruments that exhibit market behaviour similar to equities.

#### Examples of instruments with equity-like behaviour

- (i) common shares (whether voting or non-voting)
- (ii) investments in Islamic collective investment schemes
- (iii) convertible securities and commitments to buy or sell equity securities
- (iv) convertible bonds that trade like equities.



- (2) An Islamic Bank may report short and long positions in instruments relating to the same issuer on a net basis.
- (3) An Islamic Bank must calculate the long or short position in the equity market on a market-by-market basis. That is, an Islamic Bank must make a separate capital calculation for each exchange in which it holds equities (whether or not a recognised exchange).

#### 8.39. What to include in equity position risk

- (1) In calculating the capital charge for equity position risk, an Islamic Bank must include equity *Shari'ah*-compliant hedging instruments and off-balance-sheet positions that are affected by changes in equity prices.
- (2) To calculate the charges for equity position risk for equity *Shari'ah*-compliant hedging instruments and other off-balance-sheet positions, an Islamic Bank must convert positions into notional equity positions, so that:
  - (a) equity *Shari'ah*-compliant hedging instruments and off-balance-sheet positions relating to individual equities are reported at current market prices;
  - (b) equity *Shari'ah*-compliant hedging instruments and off-balance-sheet positions relating to stock indices are reported as the mark-to-market value of the notional underlying equity portfolio; and
  - (c) equity swaps are treated as 2 notional positions.

#### 8.40. Charges for specific and general risks

- (1) The capital charge for equity position risk consists of 2 separately calculated charges:
  - (a) a charge for the specific risk of holding a long or short position in an individual equity; and
  - (b) a charge for the general risk of holding a long or short position in the market as a whole.
- (2) The capital charge for specific risk is 8% on the gross position of an Islamic Bank in equities listed on a recognised exchange and 12% on the gross position of an Islamic Bank in other equities. **Gross position**, of a firm in an equity market, is the sum of the absolute values of all short equity positions and all long equity positions of an Islamic Bank.
- (3) The capital charge for general risk is 8% on the net position of an Islamic Bank. **Net position**, of a firm in an equity market, is the difference between long equity positions and short equity positions of an Islamic Bank.
- (4) **Equity position** is the net of short and long exposures to an individual company. It is measured on the gross position across the company (rather than individual transactions).

#### 8.41. Offsetting positions

- (1) If an Islamic Bank takes a position in depository receipts against an opposite position in the underlying equity (whether or not listed in the same country where the receipts were issued), it may offset the positions only if any costs on conversion are taken into account in full.



- (2) An Islamic Bank may offset matched positions in an identical equity or stock index in each market, resulting in a single net long or short position to which the specific and general risk capital charges are to be applied. For this purpose, a future in an equity may be offset against an opposite physical position in the same equity.

#### 8.42. Charges for index contracts

- (1) For an index contract on an index that an Islamic Bank considers diversified, an Islamic Bank must apply a general risk capital charge of 8%, and a specific risk capital charge of 2%, to the net long or short position in the contract.
- (2) For any other index contract, an Islamic Bank must apply a general risk capital charge of 8%, and a specific risk capital charge of 4%, to the net long or short position in the contract.
- (3) If required to do so by the AFSA, an Islamic Bank must demonstrate why it considers an index to be a diversified index.

#### Guidance

An Islamic Bank should test diversification against the following criteria used by the European Banking Authority:

- (i) The index must have a minimum number of equities. There must be an absolute threshold below which the index cannot be considered sufficiently diversified to ignore the specific risk completely.
- (ii) None of the equities must significantly influence the volatility of the index. Equities must not represent more than a certain percentage of the total index value.
- (iii) The index must have equities diversified from a geographical perspective.
- (iv) The index must represent equities that are diversified from an economic perspective. Different 'industries' must be represented in the index.

#### 8.43. Profit rate risk in the Trading Book

In measuring its Market Risk, an Islamic Bank must include the risk of holding or taking positions in *sukuk* and other *Shari'ah*-compliant debt securities and profit-rate-related instruments that are held in the Trading Book (profit rate risk in the Trading Book).

#### 8.44. What to include in profit rate risk

- (1) The measurement of profit rate risk in the Trading Book applies to all fixed-rate and floating-rate debt securities and other profit-rate-related instruments that exhibit market behaviour similar to debt securities.

#### Examples

- (i) fixed-rate and floating-rate *sukuk*
- (ii) non-convertible preference shares
- (iii) convertible *sukuk* that trade like debt securities.



- (2) A debt security that is the subject of a repurchase or securities financing agreement is taken to be owned by the lender of the security.
- (3) In calculating the capital charge for profit rate risk in the Trading Book, an Islamic Bank must include profit rate exposures arising from binding unilateral promises in foreign exchange transactions and forward sales and purchases of commodities and equities.
- (4) An Islamic Bank must also include any profit rate exposures arising from foreign exchange, commodity and equity positions.

#### **8.45. Capital charge—profit rate risk**

The capital charge for profit rate risk in the Trading Book consists of 2 separately calculated charges:

- (a) a charge for the specific risk of holding a long or short position in an individual instrument; and
- (b) a charge for the general risk of holding a long or short position in the market as a whole.

##### **Guidance**

The capital charge for general risk is for the risk of loss arising from changes in market profit rates.

##### **Specific risk**

#### **8.46. Calculating specific risk capital charge**

- (1) The capital charge for specific risk arising from an on-balance-sheet or off-balance-sheet profit-rate position held in an Islamic Bank's Trading Book is calculated by multiplying the market value of the debt security by the applicable charge set out in column 5 of table 8.46 A for the category and residual maturity of the instrument.
- (2) An Islamic Bank can only offset matched long and short positions (including positions in *Shari'ah*-compliant hedging instruments) in identical instruments with exactly the same issuer, profit rate, currency and maturity.



**Table 8.46 A Specific risk capital charges**

Item	Category	External Credit Rating	Residual Maturity	Specific Risk Capital Charge %
1	government	AAA to AA-		0.00
		A+ to BBB-	6 months or less	0.25
			more than 6 months and up to and including 24 months	1.00
			more than 24 months	1.60
		BB+ to B- or unrated		8.00
		Below B-		12.00
2	qualifying		6 months or less	0.25
			more than 6 months and up to and including 24 months	1.00
			more than 24 months	1.60
3	other	BB+ to BB- or unrated		8.00
		Below BB-		12.00

(3) In column 2 of table 8.46 A:

**government**, as a category, includes all forms of government paper such as bonds, treasury bills and other short-term instruments.

**qualifying**, as a category, includes:



- (a) securities issued by public sector enterprises and multilateral development banks;
- (b) instruments rated investment grade by at least 2 ECRA's;
- (c) instruments rated investment grade by 1 ECRA and 1 other credit rating agency that is not an ECRA; and
- (d) unrated instruments, but only if:
  - (i) an Islamic Bank has no reason to suspect that the particular instrument would have a rating less than investment grade if it were rated; and
  - (ii) the issuer of the instrument is rated investment grade and is regulated in its home jurisdiction in a way comparable to deposit-takers in the AIFC.

**other**, as a category, includes:

- (a) instruments issued or fully guaranteed by the central government or central bank of a state that is a member of the OECD;
  - (b) instruments fully collateralised by instruments described in paragraph (a); and
  - (c) instruments issued or fully guaranteed by the central government or central bank of a state that is not a member of the OECD, but only if:
    - (i) the instruments have a residual maturity of 1 year or less;
    - (ii) the instruments are denominated in the local currency of the issuer; and
    - (iii) an Islamic Bank's holdings in such instruments are funded by liabilities in the same currency.
- (4) In column 3 of table 8.46 A, **external credit rating** means a long-term rating issued by an ECRA for the purpose of risk-weighting claims on rated counterparties and exposures.

### Guidance

Financial instruments issued by Kazakhstan (whether denominated in Kazakhstani tenge or not), or by other member states of the GCC, are risk-weighted at zero per cent. In deciding whether an issuer is regulated in a comparable way, an Islamic Bank must look, in particular, at the home jurisdiction's risk-based capital requirements and consolidated supervision.

#### 8.47. Instruments that have no specific risk capital charge

- (1) Profit rate swaps, cross-currency swaps and binding unilateral promises in foreign exchange transactions are exempt from specific risk capital charges. However, a specific risk capital charge must be calculated if the underlying is a debt security or an index representing a basket of Shariah compliant securities.
- (2) Shariah compliant forward contracts and binding unilateral promises (other than those in foreign exchange transactions) are exempt from specific risk capital charges if:
  - (a) the Islamic Bank has a right to substitute cash settlement for physical delivery under the contract; and



- (b) the price on settlement is calculated with reference to a general market price indicator.
- (3) A contract or promise that is exempt under (2) above must not be offset against specific securities (including those securities that make up the market index).

**General risk****8.48. Measuring general risk**

- (1) General risk is measured using the maturity method. In that method, positions are allocated to a maturity ladder before the capital charge is calculated.
- (2) An Islamic Bank must add the absolute values of the individual net positions within each time band, whether long or short. The sum of the absolute values is an Islamic Bank's gross position.

**8.49. Maturity method**

- (1) In the maturity method, long or short positions in debt securities, *Shari'ah*-compliant hedging instruments and other sources of profit rate exposures are allocated to the time bands in table 8.50 A (and then to the zones in table 8.50 B) based on residual maturity and profit rate.
- (2) An Islamic Bank must allocate:
  - (a) positions in fixed-rate instruments according to their residual term to maturity; and
  - (b) positions in floating-rate instruments according to the residual term to the next re-pricing date.
- (3) An Islamic Bank may offset:
  - (a) long and short positions (whether actual or notional) in identical instruments with exactly the same issuer, profit rate, currency and maturity; and
  - (b) matched swaps and binding unilateral promises that satisfy the criteria in Rule 8.55.

**8.50. Steps in calculating general risk capital charge**

The steps to calculate the general risk capital charge are:

**Step 1**

Weight the positions in each time band by the risk factor corresponding to those positions in table 8.50 A.

**Table 8.50 A Time Bands and risk factors**

Item	Time Band	Risk Factor %	Assumed Changes In Yield, %
1	1 month or less	0.00	1.00
2	more than 1 and up to 3 months	0.20	1.00



3	more than 3 and up to 6 months	0.40	1.00
4	more than 6 and up to 12 months	0.70	1.00
5	more than 1 and up to 2 years	1.25	0.90
6	more than 2 and up to 3 years	1.75	0.80
7	more than 3 and up to 4 years	2.25	0.75
8	more than 4 and up to 5 years	2.75	0.75
9	more than 5 and up to 7 years	3.25	0.70
10	more than 7 and up to 10 years	3.75	0.65
11	more than 10 and up to 15 years	4.50	0.60
12	more than 15 years and up to 20 years	5.25	0.60
13	more than 20 years	6.00	0.60

## Step 2

Offset the weighted long and short positions within each time band.

### Example

If the sum of the weighted long positions in a time band is KZT100 million and the sum of the weighted short positions in the band is KZT90 million, you offset the positions to come up with a matched position of KZT90 million and unmatched position of KZT10 million.

## Step 3

For each time band, apply a 10% capital charge (vertical disallowance) on the matched position calculated in step 2.

### Example

Continuing on from the example in step 2, apply the 10% on the KZT90 million matched position to come up with a KZT9 million vertical disallowance for the time band.

## Step 4

For the unmatched positions calculated in step 2, carry out 2 further rounds of offsetting using the zones (made up of time bands) in table 8.50 B and apply the appropriate capital charge, as follows:

- (a) first between the remaining unmatched positions within each of 3 zones and subject to a charge (expressed as a percentage) as follows:
  - (i) matched weighted positions within zone 1 x 40%;





- (ii) matched weighted positions within zone 2 x 30%;
- (iii) matched weighted positions within zone 3 x 30%;
- (b) subsequently between the remaining unmatched positions across the 3 different zones (in the order set out below) and subject to a capital charge as follows:
  - (i) matched weighted positions between zones 1 and 2 x 40%;
  - (ii) matched weighted positions between zones 2 and 3 x 40%;
  - (iii) matched weighted positions between zones 1 and 3 x 100%.

The absolute value of the net amount remaining is the **net position**.

**Table 8.50 B Zones for profit rate**

Item	Zone	Time Bands
1	zone 1	0 – 1 month 1 – 3 months 3 – 6 months 6 – 12 months
2	zone 2	1 – 2 years 2 – 3 years 3 – 4 years
3	zone 3	4 – 5 years 5 – 7 years 7 – 10 years 10 – 15 years 15 – 20 years more than 20 years

#### Step 5

Calculate the horizontal allowance by adding the charges from paragraphs (a) and (b) of step 4.

#### Step 6

Calculate the general risk capital charge as the sum of:

- (a) the net position calculated from steps 1 to 4;



- (b) the vertical disallowance from step 3;
- (c) the horizontal disallowance from steps 4 and 5; and
- (d) the net charge for positions in options, where appropriate, calculated in accordance with Rule 8.19.

#### 8.51. Positions in currencies

- (1) An Islamic Bank must use separate maturity ladders for positions in each currency, with capital charges calculated separately for each currency and then summed. Positions in different currencies are not to be offset.
- (2) If an Islamic Bank's position in a currency is less than 5% of the value of an Islamic Bank's Banking Book assets, that currency is taken to be a **residual currency** and an Islamic Bank may use a single maturity ladder for all residual currencies (instead of having to use separate maturity ladders for each currency). An Islamic Bank must enter, into each appropriate time band, the net long or short position for residual currencies.
- (3) An Islamic Bank must apply, with no further offsets, the risk factor in column 3 of table 8.50 A to the position in each time band for residual currencies.

#### 8.52. Binding unilateral promises

- (1) An Islamic Bank must treat a binding unilateral promise on bank or corporate debt as a long position or a short position in the underlying debt security. A binding unilateral promise that is not on bank or corporate debt must be treated as a long position or a short position in a notional government security.
- (2) If a range of instruments may be delivered to fulfil a contract, an Islamic Bank may choose the deliverable security to be allocated to the maturity ladder. An Islamic Bank must, however, take account of any conversion factor specified by the exchange where the instrument must be delivered.

#### 8.53. Swaps

- (1) An Islamic Bank must treat a swap as 2 notional positions in government securities with maturities. Both legs of the swap must be reported at their market values.
- (2) For swaps that pay or receive a fixed or floating profit rate against some other reference price (for example, a stock index), an Islamic Bank must:
  - (a) enter the profit rate component into the appropriate maturity category; and
  - (b) include any equity component in the measurement of equity risk.
- (3) Each leg of a cross-currency swap must be reported in the maturity ladder for the currency concerned. The capital charge for any foreign exchange risk arising from the swaps must be calculated in accordance with Rules 8.14 to 8.17.

#### 8.54. Shari'ah-compliant hedging instruments

- (1) In the measurement of profit rate risk in the Trading Book, an Islamic Bank must include profit rate *Shari'ah*-compliant hedging instruments and off-balance-sheet instruments in the Trading Book if those instruments react to changes in profit rates.



- (2) An Islamic Bank must convert *Shari'ah*-compliant hedging instruments into positions in the relevant underlying to enable an Islamic Bank to calculate specific and general risk capital charges. To determine the capital charges, the value of the positions must be the market value of the underlying or notional underlying.
- (3) Positions in *Shari'ah*-compliant hedging instruments are subject to charges for general risk in the same way as cash positions. However, matched positions are exempt from the charges if the positions satisfy the criteria in Rule 8.55 or 8.56.
- (4) Positions in *Shari'ah*-compliant hedging instruments must be allocated to a maturity ladder and treated in accordance with this rule and the maturity method.

**8.55. Criteria for matching *Shari'ah*-compliant hedging instrument positions**

- (1) An Islamic Bank may offset a matched position in *Shari'ah*-compliant hedging instruments if the positions relate to the same underlying instruments, have the same nominal value and are denominated in the same currency.
- (2) For swaps and binding unilateral promises:
  - (a) the reference rate (for floating-rate positions) must be identical and the profit rate must differ by no more than 15 basis points; and
  - (b) the next profit-fixing date (or, for fixed-profit-rate positions or binding unilateral promises, the residual maturity) must comply with the following requirements:
    - (i) if either instrument has a profit-fixing date or residual maturity up to and including 1 month in the future, the dates or residual maturities must be the same for both instruments;
    - (ii) if either instrument has a profit-fixing date or residual maturity more than 1 month, but no more than 1 year, in the future, the dates or residual maturities must be within 7 days of each other;
    - (iii) if either instrument has a profit-fixing date or residual maturity more than 1 year in the future, the dates or residual maturities must be within 30 days of each other.
- (3) An Islamic Bank that writes options may offset the delta-equivalent values of options (including the delta-equivalent value of legs arising out of the treatment of caps and floors in accordance with delta-plus method in Rule 8.24).
- (4) However, for offsetting between a matched position in a binding unilateral promise and its underlying, Rule 8.56 applies.

**8.56. Criteria for offsetting *Shari'ah*-compliant hedging instrument positions**

- (1) An Islamic Bank may offset long and short positions (whether actual or notional) in identical instruments with exactly the same issuer, profit rate, currency and maturity.
- (2) An Islamic Bank may offset a matched position in a binding unilateral promise and its corresponding underlying. The net position must be reported.
- (3) An Islamic Bank may offset positions in a binding unilateral promise with a range of deliverable instruments and the corresponding underlying only if:



- (a) there is a readily identifiable underlying Shariah compliant security; and
  - (b) the price of that security and the price of the binding unilateral promise move in close alignment.
- (4) An Islamic Bank must treat each leg of a cross-currency swap or binding unilateral promise in foreign exchange transaction as a notional position in the relevant instrument, and must include the position in the calculation for each currency.

#### 8.57. Market Risk capital charges for Islamic financial contracts

This section describes and sets out the Market Risk capital charges applicable to the main types of Islamic Financial Contracts typically employed by Islamic Banks across the world.

##### Sale-based contracts

#### 8.58. Treatment of *murabahah* and related contracts

- (1) An Islamic Bank is exposed to Market Risk under a *murabahah* contract when the asset is available for sale and on firm's balance sheet.
- (2) The capital charge for a *murabahah* contract is 15% on the position. There is no capital charge for a binding MPO contract or a CMT.

##### Guidance

In the case of a CMT where an Islamic Bank holds on to the commodity for a longer period than normal (for example, following the customer's refusal to honour its commitment to buy) the commodity is subject to a capital charge of 15%.

#### 8.59. Treatment of *bai bithaman ajil*

The capital charge for a *bai bithaman ajil* contract is 15% on the position. There is no capital charge for a commodity *bai bithaman ajil*.

#### 8.60. Treatment of *salam* and related contracts

Under a *salam* contract, an Islamic Bank is exposed to Market Risk after an Islamic Bank has paid the purchase price to the seller and before the purchased commodity is sold and delivered to a buyer.

**Table 8.60 A Market Risk capital charge for *salam* without parallel *salam***

Stage of contract	Capital charge
firm has paid purchase price to <i>salam</i> customer (seller)	15% on the long position of <i>salam</i> exposures
firm has received purchased commodity but has not sold and delivered the commodity to a buyer	


**Table 8.60 B Market Risk capital charge for *salam* with parallel *salam***

Stage of contract	Capital charge
firm has paid purchase price to <i>salam</i> customer (seller)	15% on the net position (that is, after netting of <i>salam</i> exposures against parallel <i>salam</i> exposures)
firm has received purchased commodity but has not sold and delivered the commodity to a buyer	plus 3% on the gross position (that is, the sum of the <i>salam</i> exposures and parallel <i>salam</i> exposures)
Note: The parallel <i>salam</i> does not extinguish the requirement for capital from the first <i>salam</i> contract.	

**8.61. Treatment of *istisna* without parallel *istisna***

- (1) If an Islamic Bank is the seller under an *istisna* without parallel *istisna* contract, an Islamic Bank is exposed to Market Risk when there is unbilled work-in-process inventory. The capital charge for the contract is 1.6% of an Islamic Bank's unbilled work-in-process inventory.
- (2) If an Islamic Bank is the buyer under an *istisna* without parallel *istisna* contract, an Islamic Bank is exposed to Market Risk as it makes progress payments to the supplier. The capital charge for the contract is 15% of the work-in-process inventory.

**8.62. Treatment of *istisna* with parallel *istisna***

- (1) There is no capital charge for an *istisna* with parallel *istisna* contract if there is no provision in the parallel *istisna* contract that allows the seller to increase or vary the selling price. Also, there is no capital charge if there is a written undertaking given to an Islamic Bank that the contractor's performance (including work-in-process) is the responsibility of the ultimate customer.
- (2) However, there is a Capital charge of 1.6% of an Islamic Bank's unbilled work-in-process inventory if:
  - (a) there is a provision in the parallel *istisna* contract that allows the seller to increase or vary the selling price; or
  - (b) there is no written undertaking that the contractor's performance is the responsibility of the ultimate customer.

**Lease-based contracts**
**8.63. Treatment of *ijarah* and related contracts**

- (1) For an operating *ijarah*, an Islamic Bank is exposed to Market Risk (from possible fluctuations in the price of the asset) and is subject to capital charges as follows:
  - (a) 8% of the residual value of the asset during the lease;
  - (b) 15% of the carrying value of the asset after the expiry of the lease contract until the asset is re-leased or disposed of.
- (2) There is no capital charge for an IMB contract or any other *ijarah* contract.



## Equity-based contracts

### 8.64. Treatment of diminishing *musharakah*

- (1) The capital charge for a diminishing *musharakah* contract depends on the category of the enterprise or asset to which the contract relates.
- (2) If the contract is in relation to a private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities, the capital charge depends on the underlying asset as set out in this chapter.
- (3) If the contract is in relation to a joint ownership of real estate or movable assets through *musharakah* with *murabahah* subcontract, the capital charge is 15% (that is, the charge for the *murabahah* subcontract, as set out in Rule 8.58).
- (4) If the contract is in relation to a joint ownership of real estate or movable assets through *musharakah* with *ijarah* subcontract, the capital charge is 8% or 15% (that is, the charge for the *ijarah* subcontract, as set out in Rule 8.63).

### 8.65. Treatment of *mudarabah*

- (1) The capital charge for a *mudarabah* contract depends on the category of the enterprise or asset to which the contract relates.
- (2) If the contract is in relation to a private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities, the capital charge depends on the underlying asset as set out in this chapter.
- (3) If the contract is in relation to a placement in the interbank market, there is no capital charge except if the funds are invested in foreign exchange. The capital charge for a *mudarabah* contract where the funds are invested in foreign exchange is that calculated in accordance with Rule 8.14 (foreign exchange risk).

## Loan-based contracts

### 8.66. Treatment of *qardh*

There is no capital charge for a *qardh* contract except if the loan is provided in a foreign currency or in the form of a commodity. For *qardh*-based financing in a foreign currency or commodity, the capital charge is that calculated in accordance with Rule 8.14 (foreign exchange risk) or Rule 8.29 (commodities risk), as the case requires.

## Service-based contracts

### 8.67. Treatment of *wakalah*

- (1) If a *wakalah* contract is in relation to a private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities, the capital charge depends on the underlying asset as set out in this chapter.
- (2) If the contract is in relation to a placement in the interbank market, there is no capital charge except if the funds are invested in foreign exchange. The capital charge for a *wakalah* contract where the funds are invested in foreign exchange is that calculated in accordance with Rule 8.14 (foreign exchange risk).



## 9. OPERATIONAL RISK

### 9.1. General

- (1) Rules 9.1 to 9.9 of this Chapter sets out the requirements for an Islamic Bank's Operational Risk management policy to identify, measure, evaluate, manage and control or mitigate Operational Risk. Rule 9.11 gives guidance on Operational Risk as it relates to Islamic financial contracts.
- (2) **Operational Risk** is the risk resulting from inadequate or failed internal processes, people and systems, or from external events. It can be classified into general risk, *Shari'ah* non-compliance risk and legal risk.
- (3) Operational Risk does not include strategic risk and reputational risk.
- (4) Part of an Islamic Bank's general Operational Risk arises from banking operations that are common to all financial institutions. For example, an Islamic Bank must ensure that its critical payments are made promptly in order to avoid systemic disruptions to other payment systems and money markets.
- (5) The other part arises from the features specific to Islamic finance products and/or services including the structure, execution, manner of delivery, particular set of process, etc, and the asset-backed or based nature of its financial products. For example, *murabahah*, *salam*, *istisna* and *ijarah* may give rise to additional forms of Operational Risk in contract drafting and execution.

#### Guidance

Although the Operational Risk that could arise for Islamic Banks can be considered similar to that of conventional banks, the characteristics of such risk may be different, thus:

- (a) *Shari'ah*-compliant products may involve processing steps different from those of their conventional counterparts
- (b) the assets held on the balance sheets of Islamic Banks (physical assets and real estate) are different from those of conventional banks
- (c) the requirements of *Shari'ah*-compliance result in different risks relating to information technology products and systems.

### 9.2. Operational Risk—*Shari'ah* non-compliance

- (1) ***Shari'ah non-compliance risk***, of an Islamic Bank, is the risk of non-compliance resulting from the failure of an Islamic Bank's *Shari'ah* compliance policy to ensure that *Shari'ah* rules and principles (as determined by its *Shari'ah* supervisory board) are complied with.
- (2) The risk can lead to non-recognition of an Islamic Bank's income, and resultant losses. For *sukuk*, the risk may adversely affect the marketability (and, therefore, the value) of the *sukuk*.
- (3) The risk may cause adverse effect to the reputation of an Islamic Bank. It may also shake the public confidence and/or customers' trust in an Islamic Bank and/or its products and service.





- (4) *Shari'ah* non-compliance risk can take 3 forms:
- (a) the risk arising from mistaken and/or shortcomings in the application of *Shari'ah* principles in an Islamic Bank's processes, procedures and/or products and services, including the risk that a transaction or contract is void ab initio;
  - (b) the risk relating to potential non-compliance with *Shari'ah* rules and principles in an Islamic Bank's operations, including the risk that non-permissible income is recognised; and
  - (c) the risk relating to an Islamic Bank's fiduciary responsibilities as *mudarib* towards fund providers under a *mudarabah* contract, according to which, in the case of negligence, misconduct, fraud or breach of contract by the *mudarib*, the funds provided by the fund providers become a liability of the *mudarib*.

### 9.3. Operational Risk—legal

- (1) **Legal risk**, of an Islamic Bank, includes exposures to fines, penalties or punitive damages resulting from supervisory actions as well as private settlements.
- (2) The risk can arise from:
  - (a) an Islamic Bank's operations (that is, from legal risks common to all financial institutions); or
  - (b) problems of legal uncertainty in interpreting and enforcing contracts based on *Shari'ah*; or
  - (c) mismatch between the applicable law in a given jurisdiction (including mandatory procedures, etc) and the requirements of *Shari'ah* that may render certain products and/or services cannot be offered by an Islamic Bank due to such legal constraints.
- (3) Legal risk also includes the risk that *sukuk* in which an Islamic Bank is the originator, sponsor or manager fail to perform as intended because of a legal deficiency.

### 9.4. Role of Governing Body—Operational Risk

- (1) An Islamic Bank's Governing Body must ensure that an Islamic Bank's Operational Risk management policy addresses, on a firm-wide basis, all the major aspects of Operational Risk in an Islamic Bank's business.
- (2) In particular, the Governing Body must ensure that a *Shari'ah* governance mechanism is incorporated into an Islamic Bank's Operational Risk management policy and that there is appropriate cooperation and communication between an Islamic Bank's risk management function, Governing Body and the *Shari'ah* supervisory board.

### 9.5. Powers of the AFSA

If the AFSA identifies points of exposure or vulnerability to Operational Risk that are common to 2 or more Islamic Banks, it may impose specific Capital Requirements or limits on each affected firm.

#### Examples

- (i) outsourcing of important operations by many Islamic Banks to a single provider





- (ii) severe disruption to providers of payment and settlement services.

#### 9.6. Policies—compliance with *Shari'ah*

An Islamic Bank must establish and implement policies to ensure that its business is conducted in accordance with *Shari'ah*. The policies must include effective and comprehensive procedures so that an Islamic Bank complies with:

- (a) *Shari'ah* (in general and in relation to the requirements for Islamic financial contracts); and
- (b) the fatwas, rulings and guidelines issued by its *Shari'ah* supervisory board.

#### 9.7. Policies—business continuity

- (1) An Islamic bank's Operational Risk management policy must include effective and comprehensive procedures for disaster recovery and business continuity.
- (2) An Islamic Bank must have a business continuity plan for possible scenarios of severe business disruption. The plan must provide for an Islamic Bank to continue to operate as a going concern, and to minimise losses (especially those from disturbances to payment and settlement systems), in those scenarios.

#### 9.8. Policies—information infrastructure

- (1) An Islamic Bank must establish and implement appropriate information technology policies for the accurate and timely identification, measurement, evaluation, management and control or mitigation of Operational Risk. In particular, the policies must enable an Islamic Bank to maintain an adequate and sound information infrastructure:
  - (a) that meets an Islamic Bank's current and projected requirements (under normal circumstances and in times of stress);
  - (b) that ensures that the data, and the system itself, remain secure and available; and
  - (c) that supports integrated and comprehensive risk management.
- (2) An Islamic Bank's information infrastructure must enable an Islamic Bank to compile and analyse Operational Risk data, and must facilitate reporting to an Islamic Bank's Governing Body and senior management and the AFSA.
- (3) An Islamic Bank must have appropriate reporting procedures to keep the AFSA informed of developments affecting Operational Risk at an Islamic Bank.

#### 9.9. Policies—outsourcing

- (1) An Islamic Bank must establish appropriate policies to assess, manage and monitor outsourced activities. The management of those activities must include:
  - (a) carrying out due diligence for selecting service providers;
  - (b) structuring outsourcing arrangements;
  - (c) managing and reporting the risks associated with an outsourcing;
  - (d) ensuring effective control over an outsourcing; and



- (e) contingency planning.
- (2) The outsourcing policies must require an Islamic Bank to have comprehensive contracts and service level agreements. The contract and agreements must clearly state the allocation of responsibilities between service providers and an Islamic Bank.

#### 9.10. Operational Risk Capital Requirement - Basic indicator approach

- (1) An Islamic Bank must use the basic indicator approach to Operational Risk. Operational Risk Capital Requirement is the amount of capital that an Islamic Bank must have to cover its Operational Risk.
- (2) An Islamic Bank's Operational Risk Capital Requirement is calculated in accordance with the following formula:

$$\frac{GI \times \alpha}{n}$$

where:

**GI** is an Islamic Bank's average annual gross income (as defined in sub-rule (3) below) for those years (out of the previous 3 years) for which an Islamic Bank's annual gross income is more than zero.

**$\alpha$**  is 15% or a higher percentage set by the AFSA.

**$n$**  is the number of years out of the previous 3 years for which an Islamic Bank's gross income is more than zero.

- (3) **Gross income**, for a year, means the total of the following income for the year:
  - (a) net income from financing activities, which is gross of provisions, operating expenses and depreciation of *ijarah* assets;
  - (b) net income from investment activities, which includes an Islamic Bank's share of profit from *mudarabah* and *musharakah*;
  - (c) fee income, which includes commissions and agency fees;

less an Islamic Bank's share in income attributable to IAHs and other account holders.

- (4) **Gross income** excludes:
  - (a) realised profits from the sale of securities in the Banking Book;
  - (b) realised profits from securities in the 'Held to Maturity' category in the Banking Book;
  - (c) extraordinary or irregular items of income;
  - (d) income derived from insurance;
  - (e) any collection from previously written-off financings; and
  - (f) income obtained from the disposal of real estate and other assets during the year.



### Guidance

Because of the definitions of **GI** and **n**, figures for any year in which the annual gross income of a firm is negative or zero must be excluded from both the numerator and denominator when calculating the average.

#### 9.11. Operational Risks relating to Islamic financial contracts

An Islamic bank's failure to comply with the requirements, or any lack of precision in contract documentation, may give rise to *Shari'ah* non-compliance risk.

#### 9.12. Requirements for *murabahah* and *ijarah* contracts

- (1) The asset is in existence at the time of sale or lease or, in the case of *ijarah*, the lease contract is preceded by acquisition of the usufruct of that asset (except if the asset was agreed upon based on a general specification).
- (2) The asset is in the legal and constructive possession of the Islamic Bank when it is offered for sale or lease.
- (3) The asset is intended to be used by the buyer or lessee for activities or businesses permissible by *Shari'ah*. If the asset is leased back to its owner in the first lease period, it does not lead to a contract of *'inah*.

### Guidance

An *'inah* (also called bay *'inah* or bay-al *inah*) is a double sale by which the borrower and the lender sell and then resell an asset between them, once for cash and once for a higher price whose payment is deferred. This transaction is prohibited by the majority of *Shari'ah* scholars.

#### 9.13. Requirements for *salam* and *istisna* contracts

- (1) Sale and purchase contracts cannot be interdependent and interconditional on each other (such as *salam* and parallel *salam*, or *istisna* and parallel *istisna*).
- (2) There is no penalty clause for delay in the delivery of a commodity that is purchased under a *salam* contract. However, such a penalty clause is allowed under *istisna* and parallel *istisna*.

### Guidance

An essential characteristic of a *salam* or *istisna* contract is that the subject matter does not, and is not required to, exist physically when the parties enter into the contract.

#### 9.14. Requirements for *mudarabah* and *musharakah* contracts

- (1) The capital of the Islamic Bank should be invested in *Shari'ah*-compliant investments or business activities.
- (2) A partner in *musharakah* cannot guarantee the capital of another partner, nor may the *mudharib* guarantee the capital of the *mudarabah*.
- (3) The purchase price of another partner's share in a *musharakah* with a binding promise to purchase can only be set at market value or according to an agreement entered into at the time the contract became binding. However, the agreement should not stipulate that the share be purchased at its nominal value based on the capital originally contributed.



**9.15. Operational Risks—*murabahah***

- (1) At the time the *murabahah* contract becomes binding, it is required that an Islamic Bank has purchased the asset and had it in its legal or constructive possession before selling it to the customer. Therefore, an Islamic Bank should ensure that the legal characteristics of the contract properly match the commercial intent of the transactions.

**9.16. Operational Risks—*salam***

- (1) This rule sets out the Operational Risks that may arise when an Islamic Bank purchases from a customer, under a *salam* contract, goods against advanced payment.
- (2) If the underlying goods are agricultural commodities and the goods delivered are of an inferior quality to that specified in the contract, the Islamic Bank (as buyer) should:
  - (a) reject the goods; or
  - (b) accept them at the originally agreed price.

In the latter case, an Islamic Bank may suffer loss if it sells the goods at a lower price than would have been obtained for those specified in the contract.

- (3) The underlying goods may be delivered by the customer before the agreed date. If the goods delivered meet the contract specifications, the Islamic Bank (as buyer):
  - (a) normally has to accept the goods before the agreed delivery date; and
  - (b) may incur additional costs for storage, takaful cover and deterioration (if the goods are perishable) before the goods are resold.
- (4) An Islamic Bank may face legal risk if the goods in a parallel *salam* cannot be delivered to the parallel *salam* buyer because of:
  - (a) late delivery by the *salam* seller (the customer); or
  - (b) delay by an Islamic Bank itself.

For legal risk not to arise in such a case, the parallel *salam* buyer will have to agree to change the delivery date of the goods.

**Guidance**

In case of a parallel *salam*, however, the buyer of the commodity from the Islamic Bank may (but is not obliged to) agree to accept the goods at the contract price. In such a case, an Islamic Bank does not suffer any loss of profit

**9.17. Operational Risks—*istisna***

- (1) In the case of *istisna* with parallel *istisna*, an Islamic Bank contracts to deliver a constructed or manufactured asset and enters into a contract with a subcontractor to construct or manufacture the asset.
- (2) The reliance of an Islamic Bank on the subcontractor can expose it to various Operational Risks such as those set out in (3) to (6) below. These risks need to be managed by a combination of:



- (a) legal precautions;
  - (b) due diligence in choosing subcontractors; and
  - (c) selection of suitably qualified consultants and staff to carry out the contract with the subcontractor and, ultimately, deliver the constructed or manufactured asset to the customer.
- (3) In case of late delivery by the subcontractor, an Islamic Bank may be unable to deliver the asset to the ultimate customer on the agreed date, and can, therefore, be subject to penalties for late delivery.
- (4) In case of cost overruns during the construction or manufacturing process (because of increases in the prices of raw materials, increases in manufacturing or production costs or delays by the subcontractor), additional costs may have to be absorbed wholly or partly by an Islamic Bank, in the absence of an agreement in advance with the ultimate customer.
- (5) If the subcontractor fails to meet quality standards or other specifications agreed with the ultimate customer, an Islamic Bank may face legal risk if no agreement is reached with the subcontractor and the ultimate customer:
  - (a) for remedying the defects; or
  - (b) for reducing the contract price.
- (6) If the subcontractor fails to complete the asset on time, an Islamic Bank may have to find a replacement from the market and can, therefore, be subject to additional costs.

#### 9.18. Operational Risks—*ijarah* and IMB contracts

- (1) In an *ijarah* or *ijarah muntahiyah bittamlik* (IMB) contract, an Islamic Bank (as lessor) may face, during the period of lease, the Operational Risks set out in this rule.
- (2) The ultimate use of the *ijarah* asset should be *Shari'ah*-compliant. Otherwise, an Islamic Bank will be exposed to non-recognition of the *ijarah* income as non-permissible, and an Islamic Bank will be required to repossess the asset and find a new lessee.
- (3) If the lessee damages the asset in its possession and refuses to pay for the damage, an Islamic Bank will have to repossess the asset and take legal action to cover damages. This might involve operational and litigation costs.
- (4) In the event of severe damage or destruction of the asset without the fault of the lessee, an Islamic Bank (as lessor) is required to provide a replacement to the lessee. If the asset is not insured, an Islamic Bank will have to bear the cost of buying the new asset.
- (5) Further, if an Islamic Bank fails to provide the lessee with a replacement, the lessee may terminate the *ijarah* contract without paying the rentals for the remaining period.
- (6) In the event of default or misconduct by the lessee, an Islamic Bank may face legal risk in relation to the enforcement of its contractual right to repossess the asset.

#### 9.19. Operational Risks—*musharakah*

- (1) In a *musharakah* contract, an Islamic Bank provides financing on the basis of a profit-sharing and loss-sharing contract.



- (2) An Islamic Bank may fail to carry out adequate due diligence on the customer or the financed venture.
- (3) During the period of the investment, an Islamic Bank may fail to monitor the venture's financial performance adequately or may not receive the required information from the customer.

**9.20. Operational Risks—*mudarabah***

- (1) In a *mudarabah* contract, an Islamic Bank provides financing on the basis of a profit-sharing and loss-bearing contract.
- (2) An Islamic Bank's customer (as *mudarib*) is not required to bear any losses, in the absence of negligence, misconduct, fraud or breach of contract on its part. The customer is required to act in a fiduciary capacity as the manager of an Islamic Bank's funds.
- (3) The absence of an Islamic Bank's right to control the management of the enterprise as capital provider (*rabb al-mal*) may give rise to Operational Risk.
- (4) The customer may fail to provide an Islamic Bank with regular, adequate and reliable information about the financial performance of the venture.
- (5) An Islamic Bank may fail to carry out adequate due diligence on the customer or the financed venture.



## 10. LIQUIDITY RISK

### 10.1. General

- (1) This Chapter sets out the requirements for an Islamic bank:
  - (a) to establish and implement policies to manage Liquidity Risk; and
  - (b) to maintain an adequate level of liquidity;in compliance with *Shari'ah* rules and principles and in the context of available *Shari'ah*-compliant instruments and markets.
- (2) This chapter also requires an Islamic Bank to have sufficient *Shari'ah*-compliant resources and funding to withstand severe liquidity stress.
- (3) Liquidity Risk is the risk that a firm may not be able to meet its financial obligations as they fall due. Overall Liquidity Risk for an Islamic Bank largely depends on the mix of *Shari'ah*-compliant modes of financing and investment in its asset portfolio and the concentration of individual customers exposed to each type of contract.
- (4) An Islamic Bank's overall liquidity may be affected by other risks. Liquidity Risk is related to group risk more than any other risk because an Islamic Bank that is a member of a group could be called on to make good on commitments and guarantees in favour of the other members of its group.
- (5) Liquidity Risk can be classified into funding Liquidity Risk and market Liquidity Risk. An Islamic Bank must take into account the interaction between funding and market liquidity in its analysis of Liquidity Risk.

### 10.2. Funding Liquidity Risk

- (1) Funding Liquidity Risk, of an Islamic Bank, is the risk that an Islamic Bank will not be able to efficiently meet:
  - (a) its expected and unexpected current and future cash flow; and
  - (b) its collateral needs;without affecting its daily operations or financial condition.
- (2) Funding Liquidity Risk may arise because of unexpected withdrawals or transfers of funds by an Islamic Bank's IAHs and other account holders.
- (3) On the assets side, an Islamic Bank may face funding strain due to problems in its financing and investment portfolio. An Islamic Bank may also face Liquidity Risk because of counterparties' operational and information system failures, or because problems in a payment and settlement system result in late payment or non-payment of funds.

#### Examples of problems that may lead to Liquidity Risk

- (i) fall in the value of marketable assets held for trading or in the Banking Book;
- (ii) lack of liquid markets for holdings of *sukuk* and other *Shari'ah*-compliant instruments;





- (iii) impairment of Islamic financing assets due to the financial distress of customers;
- (iv) large drawdowns under committed line-of-credit agreements.

### 10.3. Market Liquidity Risk

**Market Liquidity Risk**, of an Islamic Bank, is the risk that an Islamic Bank cannot offset or eliminate a position at the market price because of market disruption or inadequate market depth.

#### Guidance

- i) In a period of crisis, problems with funding liquidity may lead to asset sales and may lower asset prices and affect an Islamic Bank's market liquidity. Efforts by an Islamic Bank to sell a significant amount of its assets because of doubts about their quality and future performance can affect market liquidity by reducing the price of assets.
- ii) The collapse of market liquidity is also likely when market-makers are risk-averse or lack absorption capacity. The interaction can also become significant when firms start stockpiling liquid assets because of pessimistic expectations about market conditions.
- iii) Overall market confidence is an important factor in understanding the interrelationship between funding and market liquidity. Because of the lack of depth and breadth of markets for *Shari'ah*-compliant instruments and *sukuk* and the lack of sufficiently large market-makers in such instruments, funding Liquidity Risk is likely to be transformed into market Liquidity Risk in stress events, and vice versa.

### 10.4. Liquidity Risk tolerance

- (1) **Liquidity risk tolerance** refers to both the absolute risk that an Islamic Bank is open to take and the actual limits that an Islamic Bank pursues. An Islamic Bank's Liquidity Risk tolerance must be appropriate for its business and its role in the financial system, and must be expressed in a way that clearly states that it is a trade-off between risks and profits.
- (2) In approving an Islamic Bank's Liquidity Risk tolerance, the Governing Body must ensure that the limit is commensurate with an Islamic Bank's ability to have sufficient recourse to *Shari'ah*-compliant funds to mitigate Liquidity Risk.

#### Guidance

The terms 'risk tolerance' and 'risk appetite' are used interchangeably to describe both the absolute risks that a firm is open to take (which some may call risk appetite) and the actual limits within its risk appetite that a firm pursues (which some call risk tolerance). For example, an Islamic Bank may have set, as the absolute Liquidity Risk it is willing to take, a limit of 20% (risk tolerance) but at the same time prefer to keep to an actual level of 10% (risk appetite).

### 10.5. Requirements—managing liquidity and withstanding liquidity stress

- (1) An Islamic Bank must manage Liquidity Risk. It must adopt a prudent Liquidity Risk management policy that allows it to identify, measure, evaluate, manage and control or mitigate that risk. The policy must be appropriate for the nature, scale and complexity of an Islamic Bank's business and for its risk profile.
- (2) An Islamic Bank must, at all times, maintain sufficient liquidity to meet its obligations as they fall due. It must also maintain a portfolio of high-quality liquid assets sufficient to enable an Islamic Bank to withstand any reasonably foreseeable liquidity stress.





- (3) An Islamic Bank must maintain a robust funding strategy to ensure that its activities are, and will continue to be, funded from stable sources. It must prepare a contingency funding plan to meet liquidity shortfalls.
- (4) In particular, an Islamic Bank must be able to model and monitor the contractual and behavioural profiles of its IAHs, current account holders and other fund providers. In doing so, an Islamic Bank must take account of the effects of any smoothing techniques (such as PER or IRR) that it has adopted in making profit pay outs to its IAHs.

### Guidance

An Islamic bank's liquidity management should take account of an Islamic Bank's liquidity needs under periods of liquidity stress (including those involving the loss or impairment of funding sources, whether secured or unsecured), as well as normal conditions. The source of liquidity stress could be specific to an Islamic Bank, market-wide or a combination of both.

### 10.6. Future shortfalls in liquidity

An Islamic Bank must be able to identify future shortfalls in liquidity by constructing maturity ladders based on appropriate periods.

### Guidance

Because of an Islamic bank's dual role in meeting its obligations to current and *murabahah* accounts and managing the expectations of its IAHs, an Islamic Bank should carry out liquidity cash-flow analysis periodically under various market conditions. The analysis should state the assumptions about the repayments of invested funds to IAHs, and the extent that capital erosion from investment losses is mitigated by IRR.

### 10.7. Notification about liquidity concerns

- (1) An Islamic Bank must ensure that its Governing Body and senior management are informed immediately of new and emerging liquidity concerns.

#### Examples of concerns

- (i) increasing funding costs, concentrations and requirements
  - (ii) the lack of alternative sources of funding
  - (iii) significant or persistent breaches of limits to Liquidity Risk exposures
  - (iv) any significant decline in an Islamic Bank's holdings of unencumbered high-quality liquid assets
  - (v) changes in external market conditions that could signal future difficulties
  - (vi) significant withdrawal of deposits and PSIAs.
- (2) An Islamic Bank must notify the AFSA of any significant concerns that an Islamic Bank may have about its current or future liquidity. In particular, an Islamic Bank must immediately notify the AFSA if an Islamic Bank experiences a severe liquidity stress.
- (3) The notice must describe any remedial action taken, or planned, to address the concerns or liquidity stress.



**10.8. Role of governing body— Liquidity Risk**

- (1) An Islamic Bank's Governing Body must ensure that an Islamic Bank's Liquidity Risk management policy gives an Islamic Bank a comprehensive firm-wide view of Liquidity Risk, and is consistent with an Islamic Bank's risk profile and systemic importance. It is the responsibility of the Governing Body of an Islamic bank to determine the adequacy of its liquidity requirements. The Islamic Bank must obtain additional liquid assets if its Governing Body considers that the minimum requirements do not adequately reflect the risks of its business.
- (2) The Governing Body must also ensure that:
  - (a) an Islamic Bank's senior management and other relevant staff have the necessary experience to manage Liquidity Risk and to effectively implement the Liquidity Risk management policy;
  - (b) stress-tests, funding strategies, contingency funding plans and holdings of high-quality liquid assets are effective and appropriate for an Islamic Bank; and
  - (c) an Islamic Bank's senior management:
    - (i) develops a Liquidity Risk management policy in accordance with an Islamic Bank's Liquidity Risk tolerance;
    - (ii) monitors an Islamic Bank's liquidity, and reports to the Governing Body regularly;
    - (iii) determines, and sets out in an Islamic Bank's Liquidity Risk management policy, the structure, responsibilities and controls for managing Liquidity Risk and for overseeing the liquidity positions of all legal entities, branches and subsidiaries in the jurisdictions in which an Islamic Bank is active; and
    - (iv) monitors trends and market developments that could present significant, unprecedented or complex challenges for managing Liquidity Risk so that appropriate and timely changes to the Liquidity Risk management policy can be made.
- (3) The Governing Body must regularly review reports on an Islamic Bank's liquidity and, where necessary, information on new or emerging Liquidity Risks.
- (4) The Governing Body must approve:
  - (a) its Liquidity Risk tolerance;
  - (b) its funding strategy; and
  - (c) its contingency funding plan.

**10.9. Policies— Liquidity Risk environment**

- (1) An Islamic Bank's Liquidity Risk management policy:
  - (a) must set, and must provide for the regular review of, an Islamic Bank's Liquidity Risk tolerance and other quantitative and qualitative limits to Liquidity Risk exposures and vulnerabilities;



- (b) must establish procedures, systems, processes, controls and approaches to identify, measure, evaluate, manage and control or mitigate its Liquidity Risk and to ensure the integrity of its Liquidity Risk management;
  - (c) must set out the organisational structure, and must define the responsibilities and roles, for managing Liquidity Risk;
  - (d) must describe an Islamic Bank's approach to day-to-day (and, where appropriate, intraday) liquidity management;
  - (e) must specify the criteria and responsibility for reporting, and the scope, manner and frequency of reporting, to the Governing Body or a committee of the Governing Body;
  - (f) must establish procedures for tracking and reporting exceptions to, and deviations from, limits or policies;
  - (g) must include an Islamic Bank's funding strategy and contingency funding plan; and
  - (h) must establish effective information systems to enable the identification, measurement, monitoring and control of Liquidity Risk exposures and funding needs.
- (2) The policy must enable an Islamic Bank to carry out stress-tests using various scenarios based on appropriate assumptions.
- (3) The policy must take into account an Islamic Bank's Liquidity Risk profile (including on-balance-sheet and off-balance-sheet risks) and tolerance in the context of the markets and macroeconomic conditions in which an Islamic Bank operates.
- (4) An Islamic Bank must have specific policies on:
  - (a) the composition and maturity of assets and liabilities;
  - (b) the diversity and stability of funding sources; and
  - (c) the approach to managing liquidity in different currencies, across borders, and across business lines and legal entities.

#### **10.10. Funding strategy**

- (1) An Islamic Bank must establish, and must regularly review, strategies for the ongoing measurement and monitoring of funding requirements. An Islamic Bank must identify the main factors that affect its ability to raise funds and must monitor those factors closely to ensure that its estimates of its fund-raising capacity remain valid.
- (2) An Islamic Bank's funding strategy must take into account how other risks affect an Islamic Bank's overall liquidity. The funding strategy must be supported by robust assumptions in line with an Islamic Bank's Liquidity Risk management policy and business objectives.
- (3) The strategy must include:
  - (a) an analysis of funding requirements under various scenarios;



- (b) the maintenance of a reserve of unencumbered high-quality liquid assets that can be used, without impediment, to obtain funding in times of liquidity stress;
  - (c) the regular review of, and diversification in, the sources and terms of funding;
  - (d) regular efforts to establish and maintain relationships with liability holders and funding sources; and
  - (e) the regular assessment of an Islamic Bank's capacity to sell assets and raise funds quickly.
- (4) In preparing its strategy, an Islamic Bank must be aware that sources of funding such as guarantees and other commitments that are readily available to an Islamic Bank in normal conditions may not be available in times of stress, even if the guarantee or commitment is described as irrevocable.
- (5) An Islamic Bank must inform the AFSA of any significant changes to an Islamic Bank's funding strategy.

#### **10.11. Contingency funding plan**

- (1) An Islamic Bank must have a written contingency funding plan that sets out the strategies for addressing a liquidity shortfall in an emergency. The plan must set out available funding sources and the amount of funds that an Islamic Bank estimates can be obtained from those sources.
- (2) The contingency funding plan must be flexible enough to enable an Islamic Bank to respond quickly in various situations. It must address the issues over various periods (including intraday) and must establish clear lines of responsibility and communication.
- (3) An Islamic Bank must review and update its plan every year (or more often as changing business or market circumstances require) for the Governing Body's approval.

#### **10.12. Stress-testing and Liquidity Risk tolerance**

- (1) An Islamic Bank must carry out stress-testing using various short-term and long-term firm-specific and market-wide liquidity stress scenarios, to ensure that an Islamic Bank's exposures remain within its Liquidity Risk tolerance. The tests must be carried out at intervals appropriate for the nature, scale and complexity of an Islamic Bank's business and for its risk profile.
- (2) An Islamic Bank must use conservative and regularly-reviewed assumptions in stress-testing and must use the scenarios individually and in combination.
- (3) An Islamic Bank must report to the AFSA, in the form that the AFSA directs, the results of its stress-testing. An Islamic Bank must use the results to adjust its positions, to review its Liquidity Risk management policy, and to develop effective contingency funding plans.

#### **10.13. Firms that conduct foreign currency business**

- (1) This rule applies to an Islamic Bank if:
  - (a) an Islamic Bank's foreign currency business is significant; or
  - (b) an Islamic Bank has significant exposure in a particular foreign currency.



- (2) An Islamic Bank's ***business in a currency is significant***, and an Islamic Bank's ***exposure in a currency is significant***, if 5% or more of the gross value of its balance-sheet assets, balance-sheet liabilities or off-balance-sheet financial activities is denominated in the currency.
- (3) An Islamic Bank to which this rule applies must undertake separate analysis of its policies (and monitor its liquidity needs) for each significant currency.
- (4) An Islamic Bank must carry out regular stress-testing to determine the extent of mismatches in each significant currency and, if appropriate, to set limits on its cash flow mismatches for each such currency and for all those currencies in total.
- (5) An Islamic Bank must monitor its liquidity needs in each significant currency and must be able to demonstrate to the AFSA that it can transfer liquidity from 1 currency to another across jurisdictions and legal entities.

### 10.14. Management of encumbered assets

- (1) An Islamic Bank must set a prudent limit for encumbered assets and must keep within that limit.
- (2) An Islamic Bank must keep adequate records to enable it to disclose the level of its encumbered assets to the AFSA.
- (3) An Islamic Bank must identify its needs for *Shari'ah*-compliant collateral over different periods, and must address any *Shari'ah*, legal or operational constraints on the use of such collateral.

#### Guidance

The limit for encumbered assets is intended to mitigate the risks arising from excessive levels of encumbrance in terms of the effect on an Islamic Bank's cost of funding and the implications for the sustainability of its long-term liquidity position.

### 10.15. Consequences of breaches and changes

- (1) If a Liquidity Risk limit is breached, an Islamic Bank must review the exposure and reduce it to a level that is within the limit.
- (2) An Islamic Bank must make appropriate adjustments to the management of its liquidity risk in the light of an Islamic Bank's changing risk profile, funding strategy, and developments in the markets and macroeconomic conditions in which it operates.

### 10.16. Guidance on Liquidity Risks arising from Islamic Financial Contracts

This Section gives guidance on the Liquidity Risks that may arise from various Islamic Financial Contracts. An Islamic Bank should look into risk transformation in these contracts during their various stages, because such transformations may directly or indirectly affect the liquidity of the contracts.

### 10.17. Liquidity Risks—*murabahah*

In a *murabahah* contract, an Islamic Bank's liquidity may be affected by late payment or non-payment by the customer.



#### 10.18. Liquidity Risks—commodity *murabahah*

- (1) An Islamic Bank may offer commodity *murabahah* accounts as a means of raising funds. Because raising funds in this way requires an Islamic Bank to pay back the principal and agreed share of profit to the customer on maturity, an Islamic Bank may be exposed to Liquidity Risk.
- (2) If commodity-*murabahah*-based funds (which are usually short-term in nature) are used by an Islamic Bank to finance longer-term assets, a maturity mismatch will result. Such a mismatch may become acute if an Islamic Bank has a high reliance on such deposits to fund its assets.

#### 10.19. Liquidity Risks—*salam*

In a *salam* contract, the illiquidity of commodity markets and the non-permissibility of exiting the contract before delivery can give rise to Liquidity Risk for an Islamic Bank.

#### 10.20. Liquidity Risks—*ijarah*

In an *ijarah* contract, an Islamic Bank may be exposed to Liquidity Risk because of:

- (a) late payment or non-payment of instalments by the customer;
- (b) the inability to sell or lease the asset to a new customer at the end of an earlier contract; or
- (c) default by the customer.

#### 10.21. Liquidity Risks—*mudarabah* and *musharakah*

In a *mudarabah* or *musharakah* contract, an Islamic Bank may be exposed to Liquidity Risk because of:

- (a) late payment or non-payment of profits during the contract; or
- (b) non-payment by the customer of the remaining principal at the end of the contract.

#### 10.22. Liquidity Risks—PSIA

An Islamic Bank may be affected by panic withdrawals of funds by IAHs. Such withdrawals may result from rate of return risk, *Shari'ah* non-compliance risk or reputational risk.

#### 10.23. Liquidity Risks—*qardh*

An Islamic Bank may offer unremunerated current accounts on the basis of *qardh*, under which an Islamic Bank guarantees the nominal amount of the accounts. An Islamic Bank should pay back the full amount on demand and should therefore ensure that sufficient funds are available to do so as and when the demand arises.

#### 10.24. Liquidity Requirements

- (1) The quantitative liquidity requirements and liquid asset maintenance requirements defined in this Chapter, apply to an Islamic Bank on a solo basis, unless specified.
- (2) The AFSA may require an Islamic Bank to comply with the liquidity requirements defined in this Chapter to its Financial Group, if the Islamic Bank and its Financial Group are



subject to consolidated supervision.

- (3) An Islamic Bank must calculate and comply with the following liquidity requirements, which are detailed in the remaining provisions of this Chapter:
  - (a) Liquidity Coverage Ratio;
  - (b) Net Stable Funding Ratio;
  - (c) Maturity mismatch limits.

#### 10.25. Liquidity Coverage Ratio (LCR)

- (1) The Rules 10.25 to 10.27 apply only to the Islamic Banks licensed to conduct the Regulated Activity of Islamic Banking Business. These rules regarding compliance with LCR requirement are not applicable to Islamic Broker Dealers or Islamic Financing Companies.
- (2) An Islamic Bank must, except as provided in Rule 10.26, maintain a LCR of at least 100%.
- (3) An Islamic Bank must calculate its LCR using the following formula and in accordance with the methodology, formulae, parameters and guidance set out in Appendix 1 of the IBB Module. LCR is calculated in accordance with the following formula:

$$LCR = \frac{\text{Value of stock of High Quality Liquid Assets (HQLA)}}{\text{Total Net Cash Outflows over the next 30 calendar days}} * 100$$

Note: Detailed guidance specifying the tools, methodologies, parameters and formulae for calculating the LCR are set out in Appendix 1 of this IBB Module.

- (4) An Islamic Bank must calculate its LCR on an ongoing basis and separately for each material currency, in which it does Islamic banking business. An Islamic Bank must report to the AFSA its aggregate LCR calculation in USD.
- (5) The AFSA may by written notice to an Islamic Bank in relation to the LCR requirement direct it to:
  - (a) adjust the LCR requirement;
  - (b) adjust requirements under Appendix 1 of this IBB Module for calculating its stock of HQLA or the total net cash outflows;
  - (c) alter the calculation methodologies or parameters for the purposes of the LCR requirement;
  - (d) waive the LCR requirement; or
  - (e) impose additional requirements based on its assessment of the Liquidity Risk exposure of that Islamic Bank.
- (6) If the AFSA amends any requirement under (5)(a), (b), (c) or (e), the Islamic Bank must comply with the requirement as amended. If the AFSA waives any requirement under (5)(d), the Islamic Bank need not comply with that requirement.





- (7) The procedures in Schedule 1 of the AIFC Financial Services Framework Regulations will apply to a decision of the AFSA under (5)(a), (b),(c) or (e).
- (8) If the AFSA decides to exercise its power under (5)(a),(b),(c) or (e), the Islamic Bank may refer the matter to the AIFC Court for review.
- (9) If the AFSA considers that an Islamic Bank is overly reliant on cash inflows from a single wholesale counterparty or a small number of wholesale counterparties, the AFSA may direct it on the treatment of such cash flows in the calculation of its LCR.
- (10) The AFSA may allow an Islamic Bank operating as a branch, or is a Subsidiary of an entity established outside the AIFC, to recognise, as cash inflow, access to its parent entity's funds by way of a committed funding facility, up to a limit specified in the facility documentation. The facility:
  - (a) must be an irrevocable commitment; and
  - (b) must be appropriately documented.

#### **10.26. Liquidation of assets during periods of stress**

During a period of financial or liquidity stress, an Islamic Bank may liquidate part of its stock of HQLA and use the cash generated to cover cash outflows. Its level of HQLA may fall below the levels required under its LCR requirement to the extent necessary to deal with cash outflows during that period.

#### **10.27. Notification if LCR requirement not met**

An Islamic Bank must notify the AFSA in writing immediately if it does not meet or becomes aware of circumstances that may result in it not meeting its LCR requirement. This obligation applies even during a period of stress referred to in Rule 10.26.

#### **10.28. Net Stable Funding Ratio (NSFR)**

- (1) The Rules 10.28 to 10.29 apply only to Islamic Banks licensed to conduct the Regulated Activity of Islamic Banking Business. These rules regarding compliance with NSFR requirement are not applicable to Islamic Broker Dealers nor to Islamic Financing Companies.
- (2) An Islamic Bank must calculate its NSFR using the following formula and in accordance with the methodology, formulae, parameters and guidance set out in Section E of Appendix 1 of the IBB Module. NSFR is calculated in accordance with the following formula:

$$NSFR = \frac{\text{Available Stable Funding (ASF)}}{\text{Required Stable Funding (RSF)}} * 100$$

The ASF and RSF used in this calculation of NSFR are to be determined in accordance with the methodology, formulae and guidance provided in Section B of Appendix 1 of the IBB Module.

- (3) An Islamic Bank must maintain a NSFR of at least 100%, at all times. That is, its ASF must





always be equal to or greater than its RSF.

**10.29. Notification of breach of NSFR requirement**

- (1) An Islamic Bank must notify the AFSA in writing immediately if it fails to meet, or becomes aware of circumstances that may result in it not meeting, its NSFR requirement. In the notification the Islamic Bank must clearly explain:
  - (a) why it ceased to meet, or thinks it may cease to meet, the requirement;
  - (b) when it expects to again be able to meet the requirement; and
  - (c) what it has done and will do to ensure that it meets the requirement in future, or continues to meet it, as the case requires.
- (2) An Islamic Bank that gives such a notification should discuss with the AFSA what further steps it should take to deal with the situation.

**10.30. Maturity mismatch approach**

- (1) An Islamic Bank must use the maturity mismatch approach, as set out in this rule, to measure liquidity. Under this approach, a Bank must determine the net cumulative maturity mismatch position for each time band by:
  - (a) determining, in accordance with the methodology in section C of Appendix 1 of the IBB Module, the inflows (assets) and outflows (liabilities) which are, subject to their falling within one of the time bands, to be included in the maturity ladder and at what maturities;
  - (b) inserting each inflow (asset) and outflow (liability) into one or more of the following time bands on the maturity ladder:
    - (i) sight – 8 days; or
    - (ii) sight – 1 month; and
  - (c) subtracting outflows (liabilities) from inflows (assets) in each time band.

**Note:** Detailed guidance specifying the tools, methodologies, parameters and formulae for calculating the maturity mismatch are set out in Section C of Appendix 1 of the IBB Module.

- (2) An Islamic Bank must determine a net cumulative maturity mismatch position for each time band in respect of each of the deposits it has raised as a means of funding.
- (3) An Islamic Bank must calculate its net cumulative maturity mismatch position as a percentage of the means of funding in each time band in accordance with the following formula:



$$\text{Total Deposit Net Cumulative Maturity Mismatch} = \frac{\text{Net Cumulative Maturity Mismatch}}{(\text{Total Deposits} + \text{UPSIA Accounts})} * 100$$

- (4) A Bank must ensure that its net cumulative maturity mismatch position as calculated in (3) above in each time band does not exceed the following:
  - (a) sight – 8 days, negative 15%; and
  - (b) sight – 1 month, negative 25%.
- (5) An Islamic Bank must notify the AFSA in writing immediately if it exceeds these net cumulative maturity mismatch limits.

**10.31. Recognition of funding facility from parent entity**

- (1) This rule applies to a Bank that is operating as a branch in the AIFC.
- (2) The AFSA may allow such an Islamic Bank to recognise, as an asset, access to its parent entity's funds by way of a committed funding facility, up to a limit specified in the facility documentation. The facility:
  - (a) must be an irrevocable commitment; and
  - (b) must be appropriately documented.



## **11. GROUP RISK**

### **11.1. Overview**

- (1) This Chapter sets out the requirements for an Islamic bank in relation to the management of its group risk exposure as well as the measurement of its financial group Capital Requirement and resources. Group Risk refers to the risk of potential losses incurred by a Bank on account of its relationship with other members of its Financial Group, if it were to be part of one.
- (2) Group membership can be a source of both strength and weakness to an Islamic Bank. The purpose of group risk requirements is to ensure that an Islamic Bank takes into account the risks related to its membership of a corporate group and maintains adequate capital resources so as to exceed its Financial Group Capital Requirement.
- (3) The rules in this chapter apply only to an Islamic Bank.
- (4) This Chapter includes requirements that an Islamic Bank implement:
  - (a) an effective management framework for Group Risk exposure;
  - (b) the specified methodology for the calculation of Financial Group capital resources and Financial Group Capital Requirements.
- (5) This Chapter also includes requirements limiting Financial Group exposures.
- (6) The detailed requirements specifying the calculation methodologies, parameters, and guidance in respect of the primary rule requirements outlined in this Chapter are provided in Appendix 2 of the IBB. It is suggested that this Chapter of the IBB, be read in conjunction with Appendix 2 of the IBB, to facilitate understanding of the regulatory requirements and compliance with them.

### **11.2. Financial Group**

- (1) The AFSA may require an Islamic Bank to:
  - (a) form a Financial Group with any other entity within its Group; or
  - (b) include within its Financial Group any other entity within its Group;where the AFSA considers it necessary or desirable to do so in the interests of effective supervision of the Bank.
- (2) An Islamic Bank, for the purposes of this chapter, may apply to the AFSA for a written approval to exclude an entity from its Financial Group. The AFSA will grant such an approval only if the Islamic Bank satisfies the AFSA that inclusion of the entity would be misleading or inappropriate for the purposes of Financial Group supervision.
- (3) An Islamic Bank must provide to the AFSA, if requested, any of the following information in relation to its Group or Financial Group:
  - (a) details as to the entities within the Group or Financial Group;
  - (b) the structure of the Group or Financial Group; and



- (c) the systems and controls in place to manage Group Risk.

#### **Guidance**

The AFSA would consider a range of factors when requiring an Islamic Bank to treat another entity as part of its Financial Group. These factors would include regulatory risk factors, including direct and indirect participation, influence or contractual obligations, interconnectedness, intra-group exposures, intra-group services, regulatory status and legal framework.

### **11.3. Systems and Controls**

- (1) An Islamic Bank must effectively manage risks arising from its membership in a Group.
- (2) An Islamic Bank that is a member of a Group must establish and maintain systems and controls to monitor:
  - (a) the effect on the Islamic Bank of:
    - (i) its membership in its Group;
    - (ii) the activities of other members of its Group; and
    - (iii) its relationship with other members of its Group;
  - (b) compliance with Financial Group supervision and reporting requirements set out in this chapter, including systems for the production of relevant data; and
  - (c) funding within the Group.
- (3) An Islamic Bank must have systems and controls to enable it to calculate and monitor:
  - (a) its financial group Capital Requirement and
  - (b) whether Financial Group capital resources are, and are likely to remain, in compliance with the capital ratios specified in Chapter 4 of IBB Module.
- (4) Such systems and controls must include a means of analysing realistic scenarios which are relevant to the circumstances of the Financial Group; and the effects on the Financial Group Capital Requirements and on the Financial Group Capital Requirements and on the Financial Group capital resources if those scenarios occurred.

#### **Guidance**

An Islamic Bank may take advantage of its position within its Group. It would be reasonable for a small firm within a larger group to place some reliance on its parent to ensure that there are appropriate systems and controls to manage group risk.

### **11.4. Role of Governing Body**

An Islamic Bank's Governing Body must ensure that an Islamic Bank's group risk management policy addresses, on a group-wide basis, all risks arising from an Islamic Bank's relationship with every other member of its Group.



### 11.5. Financial Group Capital Requirement and resources

- (1) This Rule does not apply to an Islamic Bank if:
  - (a) an Islamic Bank is already subject to Financial Group prudential supervision by the AFSA as a result of the authorisation of another member of its Financial Group; or
  - (b) the AFSA has confirmed in writing, in response to an application from an Islamic Bank, that the AFSA is satisfied that the Islamic Bank's Financial Group is the subject of consolidated prudential supervision by an appropriate regulator

except where the AFSA has directed the inclusion of an entity pursuant to Rule 11.1, the percentage of total assets of Banks and Financial Institutions in the Financial Group is less than 40% of the total Financial Group assets.
- (2) An Islamic Bank that has received written confirmation from the AFSA, referred in 1(b) of this rule, must immediately inform the AFSA in writing if there is any change in the circumstance upon which such a confirmation was based.

### 11.6. Financial Group Capital Requirement and Regulatory Capital

- (1) An Islamic Bank must ensure, at all times, that its Financial Group Regulatory Capital exceeds its Financial Group Capital Requirement.
- (2) For the purpose of (1) above, Financial Group Regulatory Capital and Financial Group Capital Requirement must be calculated for the Financial Group as a whole, using the methods specified in Chapter 4 of IBB Module.
- (3) The capital ratios specified in chapter 4 of IBB Module, which applies to an Islamic Bank, also apply to its Financial Group. An Islamic Bank forming part of a Financial Group, must ensure that its Financial Group meets or exceeds the minimum level of capital ratios, as defined in the rules set out in Chapter 4 of the IBB Module, calculated on a consolidated basis for the entire Financial Group.
- (4) An Islamic Bank must calculate its Financial Group Capital Requirement by applying the accounting consolidation method, which calculates the Capital Requirement of the Financial Group based on the Financial Group's consolidated financial statements, and using applicable prudential rules in IBB Module. For the purposes of this rule, the consolidated financial statements of the Financial Group must be prepared in accordance with International Financial Reporting Standards (IFRS).
- (5) An Islamic Bank must calculate its Financial Group capital resources by applying either of the following methods:
  - (a) the accounting consolidation method, which calculates the capital resources of the Financial Group based on the Financial Group's consolidated financial statements; or
  - (b) the aggregation method, which is the sum of:
    - (i) the capital resources of the Parent of the Financial Group;
    - (ii) the capital resources of any Banks and Financial Institutions included in the Financial Group, less amount of investments made by one Financial Group member in another; and



- (iii) the Financial Group's proportionate share of capital resources in Financial Institutions not included in the Financial Group in which any member of the Financial Group has participation.
- (6) In calculating its Financial Group Regulatory Capital, an Islamic Bank must not include Regulatory Capital or adjusted Regulatory Capital (as the case may be) of subsidiaries or participations of that group to the extent that those Regulatory Capital or adjusted Regulatory Capital exceed the Capital Requirement for that Subsidiary or participation and are not freely transferable within the group.
- (7) Deductions for qualifying holdings set out in Chapter 4 of IBB Module may be calculated based on the Financial Group's total Tier 1 and Tier 2 Capital.

**Guidance**

- (1) Capital resources or adjusted capital resources would not be freely transferable if they are subject to an obligation to maintain minimum Capital Requirements to comply with domestic solvency requirements, or to comply with debt covenants.
- (2) If an Islamic Bank breaches Rule 11.6.(6), the AFSA would take into account the circumstances of the case, including any remedial steps taken by another regulator or an Islamic Bank, in deciding what enforcement action to take.

**11.7. Financial Group Concentration Risk limits**

- (1) Unless the AFSA directs otherwise, a prudential limit in these rules that applies to an Islamic Bank also applies to that Islamic Bank's Financial Group.
- (2) An Islamic Bank must ensure that its Financial Group's exposure to a counterparty or group of closely related counterparties does not exceed 25% of its Financial Group's capital resources.
- (3) An Islamic Bank must ensure that the sum of its Financial Group large exposures to a counterparty or group of closely related counterparties does not exceed 800% of its Financial Group's capital resources.

**Examples**

- (4) The restriction in rules relating to concentration risk (that an Islamic Bank's individual large exposure must not exceed 25% or 40% of its Regulatory Capital) applies to an Islamic Bank's group so that an Islamic Bank's group large exposure to a counterparty or connected counterparties must not exceed 25% or 40% of its group capital resources.
- (5) In a similar way, the restriction in rules relating to large exposures regime (that an Islamic Bank must ensure that the sum of its large exposures does not exceed 800% of its Regulatory Capital) applies to an Islamic Bank's group so that the sum of its group large exposures to counterparties or connected counterparties must not exceed 800% of its group capital resources.



## 12. TREATMENT OF *SUKUK*

### 12.1. General

- (1) This Chapter sets out the minimum Capital Requirements to cover the Credit Risk and Market Risk arising from the holding, by an Islamic Bank, of *sukuk* in its Banking Book.

#### Guidance

For Credit Risk arising from *sukuk* in an Islamic Bank's Trading Book, Chapter 8 applies. For Market Risk arising from *sukuk* in an Islamic Bank's Trading Book, Chapter 10 applies.

- (2) *Sukuk* are certificates that represent a holder's proportionate ownership in an undivided part of an asset or pool of assets where the holder assumes all rights and obligations to the asset or pool. A typical *sukuk* transaction would involve the originator of the *sukuk*, the issuer of the *sukuk* and an investor (*sukuk* holder).

#### Guidance

In equity-based *sukuk* (such as *musharakah sukuk* and *mudarabah sukuk*), the underlying investment does not offer predictable returns. In contrast, the underlying assets of asset-based *sukuk* (such as *salam sukuk* and *murabahah sukuk*) offer fairly predictable returns to holders.

### 12.2. Securitisation

#### Guidance

In addition to its holding of *sukuk* in the Banking Book, an Islamic Bank's *sukuk*-related exposures may arise from securitisation and an Islamic Bank being, or acting as, the *sukuk*'s:

- (a) originator;
- (b) issuer;
- (c) servicer; or
- (d) provider of credit enhancement.

These rules, the instructions for preparing returns and the returns themselves do not (yet) have provisions on securitisation and re-securitisation. Those provisions are to be inserted in the second or third phases of these rules.

### 12.3. Risk-weights for rated *sukuk*

The risk-weights for *sukuk* rated by an ECRA are those in accordance with tables 6.2 and 6.3 in Chapter 6 of this Rules.

### 12.4. Risk-weights for unrated *sukuk*

- (1) The risk-weights for unrated *sukuk* (that is, *sukuk* that are not rated or *sukuk* that are rated by a rating agency that is not an ECRA) must be determined based on the underlying structure and assets, in accordance with the Rules in this chapter.
- (2) For unrated *sukuk* that use a combination of the *Shari'ah*-compliant contracts, the Capital Requirement must be calculated taking into account the risk implications of the overall structure and assets.



**12.5. Sukuk issued by Government or National bank of Kazakhstan**

*Sukuk* issued by the Government of Kazakhstan or the National Bank of Kazakhstan are subject to a risk-weight of 0%.

**12.6. Sukuk issued by IILMC**

- (1) *Sukuk* issued by the International Islamic Liquidity Management Corporation (or **IILMC**) must be risk-weighted as if they were claims on short-term banking exposure.
- (2) Rated *sukuk* issued by IILMC are subject to the risk-weights based on their ratings, as set out in table 12.6. Unrated *sukuk* issued by IILMC are subject to 20% risk-weight.

**Table 12.6. Risk-weights for sukuk issued by IILMC**

Note In the table, the ratings are given according to Standard & Poor's conventions. If a claim or asset is not rated by Standard & Poor's, its ratings must be mapped to the equivalent Standard & Poor's rating.

AAA to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	below B-
20	20	50	50	150

**12.7. Sukuk awaiting transfer of assets**

For *sukuk* where the legal transfer of assets has not taken place, the risk-weight is that of the originator (based on the ratings issued by an ECRA), subject to any *Shari'ah*-compliant credit enhancement by the issuer. If the originator is unrated, the risk-weight is 100%.

**12.8. Sukuk with combination of assets**

- (1) *Sukuk* comprising a combination of different kinds of assets (such as shares, leasable assets, receivables from *murabahah* and receivables from *salam*) must be risk-weighted according to the respective percentages of the assets allocated in the investment.
- (2) If the Islamic Bank or the AFSA does not have any reliable information to determine the nature or basis of the underlying assets of the *sukuk*, a risk-weight of 100% must be applied if the *sukuk* are listed or 400% if the *sukuk* are unlisted.

**12.9. Salam sukuk**

- (1) *Salam sukuk* represent 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.
- (2) 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 after delivery.
- (3) In some *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. The undertaking 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.





**12.10. Treatment of *salam sukuk* without parallel *salam***

- (1) The risk-weight for *salam sukuk* without parallel *salam* must be based on the counterparty (***salam supplier***) unless the *salam* capital is guaranteed by a third party.
- (2) If the *salam* capital is guaranteed by a third party, the risk-weight must be based on the guarantor, but only if the guarantor's risk-weight is lower than that of the *salam* supplier. The risk-weight for an unrated *salam* supplier or an unrated guarantor is 100%.
- (3) The capital charge for *salam sukuk* without a parallel *salam* contract or other hedge is 15% on the long position of *salam* exposures.

**12.11. Treatment of *salam sukuk* with parallel *salam***

- (1) The risk-weight for *salam sukuk* with parallel *salam* must be based on the counterparty (***salam supplier***) unless the *salam* capital is guaranteed by a third party.
- (2) If the *salam* capital is guaranteed by a third party, the risk-weight must be based on the guarantor, but only if the guarantor's risk-weight is lower than that of the *salam* supplier. The risk-weight for an unrated *salam* supplier or an unrated guarantor is 100%.
- (3) A *salam sukuk* issuance that is structured with an undertaking from the issuer that the underlying commodity will be sold to a third party at a specified selling price (by means of a parallel *salam* contract) must carry the risk-weight of the third party.
- (4) There is no capital charge for Market Risk that consists of basis and forward gap risks (namely, the risk that the hedge may be impaired because the underlying commodity delivered may be of inferior quality or may be delivered later than the contractual date). This is because the underlying commodity is normally traded on an exchange that eliminates the risk of late delivery, non-delivery or delivery of a commodity that is of inferior quality.
- (5) The capital charge for *salam sukuk* with a parallel *salam* contract or other hedge is 15% on the net position of the *salam* exposures plus 3% on the gross position of those exposures.

**12.12. *Istisna sukuk***

- (1) *Istisna sukuk* represent fractional shares in the financing of a project to construct an asset at a price to be paid in future instalments. The total of those instalments equals the face value of the *sukuk* plus mark-up.
- (2) 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 *sukuk* issuer (as manager on behalf of the *sukuk* investors) and the construction firm.

**12.13. Treatment of *istisna sukuk* without parallel *istisna***

- (1) The risk-weight for *istisna sukuk* where there is no parallel *istisna* must be based on the issuer.
- (2) If a third party provides a guarantee, the risk-weight for the *istisna sukuk* must be based on the guarantor, but only if the guarantor's risk-weight is lower than that of the issuer. The risk-weight for an unrated issuer or an unrated guarantor is 100%.



- (3) A risk-weight of 20% must be added in the calculation of Credit Risk capital charges, in order to account for the price risk to which the underlying *istisna* is exposed.

#### 12.14. Treatment of *istisna sukuk* with parallel *istisna*

- (1) In the case of *istisna sukuk* with parallel *istisna*, the relevant asset may be constructed on behalf of an ultimate customer or off-taker with whom the Islamic Bank enters into the parallel *istisna* contract. In this case, there is a Credit Risk exposure to the ultimate customer for the payment due under the parallel contract.
- (2) The Credit Risk starts at the commencement of the construction work until the whole amount or all the instalments are paid by the ultimate customer.
- (3) The risk-weight for the credit exposure must be based on the ultimate customer.
- (4) If a third party provides a guarantee, the risk-weight must be based on the guarantor, but only if the guarantor's risk-weight is lower than that of the ultimate customer. The risk-weight for an unrated customer or an unrated guarantor is 100%.

#### 12.15. *Murabahah sukuk*

- (1) In *murabahah sukuk*, the originator (and, in some cases, the issuer) of the *sukuk* is the buyer (on credit) of the *murabahah* asset and the *sukuk* investors are the sellers (on credit) of that asset. The funds provided by the *sukuk* investors (and received by the issuer) represent the *murabahah* selling price of the asset.
- (2) The *sukuk* holders own the *murabahah* and are entitled to receive payment of that receivable (the selling price of the asset) either in instalments or in a lump sum at the end of the *murabahah* contract.

#### 12.16. Treatment of *murabahah sukuk*

- (1) The risk-weight for *murabahah sukuk* must be based on the issuer or other obligor (as rated by an ECRA). If the issuer or obligor is unrated, the risk-weight is 100%.
- (2) If the *sukuk* structure involves funding of an asset purchase in foreign currency, the relevant exposure must be calculated in accordance with Rule 8.24 (foreign exchange risk).

#### 12.17. *Ijarah* and IMB *sukuk*

- (1) *Ijarah* and IMB *sukuk* represent the holder's proportionate ownership in leased assets where the *sukuk* holders collectively assume the rights and obligations of the lessor. The *sukuk* holders are entitled to a share of the lease rentals in proportion to their ownership shares in the leased assets.
- (2) As a proportionate owner, an *ijarah* or IMB *sukuk* holder assumes a proportionate share of:
  - (a) any loss, if the leased asset is destroyed; or
  - (b) the cost of meeting the obligation to provide an alternative asset.



#### 12.18. Treatment of *ijarah* and IMB *sukuk*

The risk-weight for *ijarah* or IMB rentals must be based on the lessee's counterparty Credit Risk, since the residual value risk of the underlying asset is not borne by the *sukuk* holders.

#### 12.19. *Musharakah sukuk*

*Musharakah sukuk* represent the direct proportionate ownership shares of the holders in the assets of a private commercial enterprise or project, where the subscription money is normally used to purchase non-liquid assets.

##### Guidance

*Musharakah sukuk* are profit-sharing and loss-sharing instruments where the exposures are of the nature of equity positions in the Banking Book, except in the case of investments (normally short-term) in assets for trading purposes.

#### 12.20. Treatment of *musharakah sukuk*

- (1) The treatment of *musharakah sukuk* must be based on the intent of the underlying investments in *musharakah* as set out in this rule.
- (2) For a private commercial enterprise that undertakes trading activities, the risk-weight must be as set out in under the section earlier on Equity-based contracts and Chapter 8 (Market Risk).
- (3) For a private commercial enterprise that undertakes a business venture or project (other than an enterprise that undertakes trading activities), the risk-weight for equity participation risk in respect of an equity exposure in a business venture or project must be measured according to the section on Equity-based contracts and Chapter 8 (Market Risk).
- (4) For a joint ownership of real estate or movable assets as income-producing *musharakah* investments through leasing to third parties by means of *ijarah*, the risk-weight must be based on the counterparty (that is, the lessee).
- (5) For a joint ownership of real estate or movable assets as income-producing *musharakah* investments with *murabahah* sub-contracts, the risk-weight must be based on the underlying *murabahah* contracts and the counterparties involved in those *murabahah* contracts.

#### 12.21. *Mudarabah sukuk*

- (1) In *mudarabah sukuk*, the *sukuk* holders subscribe to the certificates issued by a *mudarib*. The holders share the profits and bear any losses arising from the *mudarabah* operations.
- (2) The returns to the holders depend on the revenue produced by the underlying investment.

#### 12.22. Treatment of *mudarabah sukuk*

- (1) The treatment of *mudarabah sukuk* must be based on the intent of the underlying investments in *mudarabah* as set out in this rule.
- (2) For a private commercial enterprise that undertakes trading activities, the risk-weight must be as set out in section under Equity-based contracts and Chapter 8 (Market Risk).



- (3) For a private commercial enterprise that undertakes a business venture or project (other than an enterprise that undertakes trading activities), the risk-weight for equity participation risk in respect of an equity exposure in a business venture or project must be measured according to section under Equity-based contracts and Chapter 8 (Market Risk).

#### 12.23. *Wakalah sukuk*

- (1) In *wakalah sukuk*, the *sukuk* holders provide the capital for *Shari'ah*-compliant investment activities, and the investment agent (*wakeel*) undertakes to invest the funds. These *sukuk* entitle the holders to a return in proportion to their investment in the underlying assets and a right (under a purchase undertaking) to buy all or a proportion of the underlying assets if specified conditions are fulfilled.
- (2) In *wakalah sukuk*, the SPV acting as the principal on behalf of the *sukuk* holders appoints a *wakeel* to invest funds provided by the *sukuk* holders into a pool of assets. The *wakeel* lends its expertise and manages those investments on behalf of the SPV for a particular period, in order to generate a return for the *sukuk* investors.
- (3) The SPV and the *wakeel* enter into a *wakalah* agreement to govern the appointment, scope of services and fees payable to the *wakeel*, if any.
- (4) The pool of assets may comprise a broad range of *Shari'ah*-compliant assets that selected by the *wakeel* for a period corresponding to the duration of the *sukuk* (for example, *Shari'ah*-compliant equities, *Shari'ah*-compliant assets such as real estate and cars, *murabahah*, *istisna*, other *sukuk*).

#### Guidance

While the *wakalah* structure has some similarities to the *mudarabah* structure, the way in which holders receive their share of profits differ:

- (a) *wakalah sukuk* holders receive the return on their investments less the management fees payable to the *wakeel*
- (b) in a *mudarabah* structure, the profits are divided between the parties according to agreed ratios.

#### 12.24. Treatment of *wakalah sukuk*

- (1) The treatment of *wakalah sukuk* must be based on the intent of the underlying investments in *wakalah* as set out in this rule.
- (2) For investments in trading activities in foreign exchange, shares or commodities, the risk-weight must be as set out as set out in the section Service-based contracts and Chapter 8 (Market Risk).
- (3) For investments in assets that can be leased or sold on a *murabahah* basis as income-producing *wakalah* investments through leasing to third parties by means of *ijarah*, the risk-weight must be based on the counterparty (that is, the lessee).
- (4) For investments in assets that can be leased or sold on a *murabahah* basis as income-producing *wakalah* investments with *murabahah* sub-contracts, the risk-weight must be based on the underlying *murabahah* contracts and the counterparties involved in those contracts.



### 13. TREATMENT OF PSIAS AND ASSOCIATED RISKS

#### 13.1. General

- (1) Islamic banks typically raise funds through PSIA, because interest-bearing deposits are not permitted by *Shari'ah*.
- (2) This Chapter sets out the treatment of unrestricted PSIA and the risks (rate of return risk, withdrawal risk and displaced commercial risk) that are associated with PSIA.
- (3) This Chapter also sets out:
  - (a) the responsibilities of an Islamic bank, as an unrestricted PSIA manager;
  - (b) the requirements for policies, warnings, terms of business, contracts and financial and other periodic statements in relation to PSIA; and
  - (c) the techniques available to an Islamic Bank to mitigate the risks associated with PSIA.

#### 13.2. PSIA

- (1) A Profit-Sharing Investment Account (or PSIA) is an account, portfolio or fund that satisfies the following conditions:
  - (a) it is managed by an authorised firm in accordance with *Shari'ah* and is held out as being *Shari'ah*-compliant;
  - (b) under a management agreement with an Islamic Bank, the IAH concerned and an Islamic Bank agree to share any profit in a specified ratio and the IAH agrees to bear any loss not caused by an Islamic Bank's negligence, misconduct, fraud or breach of contract.
- (2) A PSIA may be unrestricted or restricted. An Unrestricted PSIA (UPSIA) is a PSIA for which the IAHs authorise the PSIA manager to invest the IAHs' funds in a way that the manager considers appropriate, without any restriction as to where, how or for what purpose the funds may be invested (provided that the investments are *Shari'ah*-compliant).
- (3) A Restricted PSIA (RPSIA) is one where the IAHs authorise an Islamic Bank to invest the IAHs' funds, with specified restrictions as to where, how and for what purpose the funds may be invested.
- (4) The contractual relationship between an Islamic Bank and the IAHs under the PSIA requires the IAHs to bear the commercial risks associated with the assets funded by the PSIA. An Islamic Bank is responsible for managing the investment of the assets and has the fiduciary duty to safeguard the interest of the IAHs through sound and prudent policies in the management of the assets.

#### Guidance

PSIA is usually offered by an Islamic Bank on the basis of a *mudarabah* partnership between an Islamic Bank as the entrepreneur or *mudarib* and the IAH as the investor or *rabb al-mal*.



### 13.3. Powers of AFSA

Despite anything in these rules, the AFSA may direct an Islamic Bank to treat, or not to treat, an arrangement between an Islamic Bank and a party (for example, by way of *wakalah* or *musharakah*) to be a PSIA.

### 13.4. Role of Governing Body—PSIAs

- (1) An Islamic Bank's Governing Body must ensure that an Islamic Bank has policies that enable an Islamic Bank to prudently manage assets and risks associated with PSIAs.
- (2) It is the responsibility of the Governing Body to provide effective oversight and monitoring to ensure that PSIAs are managed in the best interests of the IAHs. In particular, the Governing Body must oversee:
  - (a) the financing and investment activities undertaken on behalf of IAHs;
  - (b) the fiduciary duties performed by an Islamic Bank to ensure that they are in accordance with the terms and conditions of the contracts between an Islamic Bank and its IAHs; and
  - (c) the level of reserves, to ensure that the level is appropriate and as fair as possible to existing and new IAHs.

### 13.5. Policies for managing PSIAs

An Islamic bank's policies on managing PSIAs must include the following:

- (a) how to ensure that PSIAs are managed in accordance with their IAHs' instructions;
- (b) how to ensure that the funds of each PSIA are invested in accordance with the relevant terms of business;
- (c) the priority of the investment of each PSIA owner's funds and those of the IAHs;
- (d) how the interests of the IAHs are safeguarded;
- (e) the basis for allocating expenses and profits or losses to IAHs;
- (f) how provisions and reserves against equity and assets will be applied;
- (g) to whom those provisions and reserves would revert in the event of a write-off or recovery;
- (h) how liquidity mismatch will be monitored;
- (i) how the value of each PSIA's assets will be monitored;
- (j) how any losses incurred as a result of negligence, misconduct, fraud or breach of contract on the part of an Islamic Bank will be dealt with;
- (k) an acknowledgment of the right of IAHs to monitor the performance of their investments and the associated risks, and how IAHs can exercise that right.

### 13.6. Warnings to investment account holders

An Islamic Bank must warn a prospective IAH in writing that:



- (a) the IAH bears the risk of loss to the extent of the IAH's investment; and
- (b) the IAH would not be able to recover that loss from an Islamic Bank, except in the case of negligence, misconduct, fraud or breach of contract on the part of an Islamic Bank.

### **13.7. Terms of business**

An Islamic Bank must ensure that the following information is included in the terms of business given to an IAH:

- (a) how and by whom the funds of the IAH will be managed and invested;
- (b) the PSIA's investment objectives and details of its policy on diversification;
- (c) the basis for allocating profits and losses;
- (d) a summary of the policies for valuing the PSIA's assets;
- (e) if an Islamic Bank uses PER or IRR as a smoothing technique, a summary of the policies for transferring funds to and from the reserve;
- (f) particulars of the management of the PSIA;
- (g) particulars of the management of any other person to whom the owner has outsourced, or will outsource, the management of the PSIA, including:
  - (i) the person's name;
  - (ii) the person's regulatory status; and
  - (iii) details of the arrangement;
- (h) details of any arrangement for early withdrawal, redemption or other exit and any costs to an IAH as a result;
- (i) confirmation of the IAH's investment objectives;
- (j) whether funds from the PSIA will be mixed with the funds of any other PSIA;
- (k) any applicable charges and the basis on which such charges will be calculated;
- (l) any fees that an Islamic Bank can deduct from the profits of the PSIA;
- (m) how the IAH can monitor the performance of investments and associated risks.

### **13.8. Form of contracts for PSIAs**

- (1) The terms and conditions of a contract for a PSIA must be clear, concise and easily understandable by an IAH. The contract must state the type, purpose, terms and period of the contract and the profit-sharing ratio agreed at the time of the opening of the account.
- (2) The following must also be stated in the contract:
  - (a) the rights and liabilities of both parties—in particular, in the circumstances where losses are to be borne by the IAH;





- (b) the implications for the IAH of early withdrawal, early redemption or other exit;
- (c) the duty of an Islamic Bank to disclose accurate, relevant and timely information to the IAH on the investment of funds, including its performance, investment strategies, valuation, and frequency of valuation of the PSIA's assets;
- (d) how any losses incurred as a result of negligence, misconduct, fraud or breach of contract on the part of an Islamic Bank will be dealt with;
- (e) how any subsequent changes in the profit-sharing ratio will be disclosed;
- (f) any smoothing techniques that an Islamic Bank uses.

### 13.9. Financial statements—specific disclosures

- (1) An Islamic Bank must ensure that its financial statements contain the following disclosures:
  - (a) the role and authority of the *Shari'ah* supervisory board in overseeing an Islamic Bank's business;
  - (b) the method used in the calculation of the zakat base;
  - (c) if *zakat* has been paid, the amount that has been paid;
  - (d) if *zakat* has not been paid, information to allow an IAH or prospective IAH to compute its liability to *zakat*.
- (2) The financial statements must also contain the following disclosures in relation to each PSIA managed by an Islamic Bank:
  - (a) an analysis of its income according to types of investments and their financing;
  - (b) the basis for allocating profits between the owner and the IAHs;
  - (c) the equity of the IAHs at the end of the reporting period;
  - (d) the basis for determining any PER or IRR;
  - (e) the changes that have occurred in any of those reserves during the reporting period;
  - (f) to whom any remaining balances of any of those reserves is attributable in the event of liquidation.
- (3) Any deductions by an Islamic Bank from its share of income, and any expenses borne by an Islamic Bank on behalf of the IAHs, as a contribution to the income of IAHs must also be disclosed in an Islamic Bank's financial statements if the contribution is significant.

### 13.10. Periodic statements

- (1) An Islamic Bank must give each IAH of a PSIA a periodic statement about the PSIA at intervals stated in the contract or terms of business. The interval must not be longer than 6 months.
- (2) An Islamic Bank must ensure that the periodic statement contains the following information as at the end of the period covered by the statement:





- (a) the number, description and value of investments held by the PSIA;
- (b) the amount of cash held by the PSIA;
- (c) details of applicable charges (including any deductions of fees that an Islamic Bank is allowed to deduct from the profits of the PSIA) and the basis on which the charges are calculated;
- (d) the total of any dividends and other benefits received by an Islamic Bank for the PSIA;
- (e) the total amount, and particulars, of all investments transferred into or out of the PSIA;
- (f) details of the performance of the IAH's investment;
- (g) the allocation of profit between the owner and the IAH;
- (h) any changes to the investment strategies that could affect the IAH's investment.

#### 13.11. PSIA accounts to be kept separate

An Islamic Bank must keep its accounts for unrestricted IAHs separate from accounts for restricted IAHs. An Islamic Bank must record all its transactions in investments for these accounts separately.

#### 13.12. Rate of return and other risks

- (1) **Rate of return risk** (or **ROR risk**) is the risk that an increase in benchmark rates may result in IAHs' having expectations of a higher rate of return. It is the risk of facing a lower rate of return on assets than currently expected by an Islamic Bank's IAHs.
- (2) Rate of return risk may result in withdrawal risk and displaced commercial risk. It can give rise to liquidity problems in an Islamic Bank.
- (3) An Islamic Bank must manage the expectations of its shareholders and IAHs. If market rates of return of competitors' IAH are higher than those of an Islamic Bank's IAHs, an Islamic Bank must evaluate the nature and extent of the expectations of its IAHs and assess the amount of the gap between competitors' rates and its own IAHs' expected rates.

#### 13.13. Withdrawal risk and displaced commercial risk

- (1) Many Islamic Banks consider their IAHs as behaving like conventional depositors who might withdraw their funds in the case of lower-than-expected profit rates (withdrawal risk). The withdrawal of funds by IAHs can expose a firm to Liquidity Risk.
- (2) Another consequence of rate of return risk may be Displaced Commercial Risk (or DCR), which is the risk resulting from competitive pressures on a firm to attract and retain IAHs as fund providers. An Islamic Bank may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAHs when the return on those assets is under-performing compared with competitors' rates.

#### Guidance



- (i) For example, an Islamic Bank that acts as *mudarib* for an IAH may give up a part of its *mudarib* share or its profit to the IAH in order to smooth profit payouts. The risk of an Islamic Bank being obliged to give up the share or profit for commercial or other reasons is a DCR.
- (ii) The term 'displaced' is used because, initially, the risk from the volatility of returns is to be borne by the IAH as *rabb-al-mal* but that risk has been displaced onto an Islamic Bank.
- (iii) If a firm is able to manage the distribution of returns on PSIAs entirely through adjustments to its PER (that is, without having to give up part or all of their *mudarib* share of profits and without making any unilateral transfer to IAHs from the shareholders' current or retained profits), there is no DCR and there is no requirement for an Islamic Bank to support an additional capital charge for that risk.

#### 13.14. Role of Governing Body—rate of return risk

- (1) An Islamic Bank's Governing Body must ensure that an Islamic Bank's rate of return risk management policy:
  - (a) gives an Islamic Bank a comprehensive firm-wide view of the significant sources of rate of return risk; and
  - (b) is consistent with an Islamic Bank's risk profile and systemic importance.
- (2) The Governing Body must also ensure that an Islamic Bank has adequate policies and staff to identify, measure, evaluate, manage and control or mitigate its rate of return risk.
- (3) The governing body must approve the basis for computing the amounts to be set aside by an Islamic Bank for the PER or IRR.
- (4) The governing body must regularly review an Islamic Bank's investment policies and the performance of the assets in which IAHs' funds are invested.

#### 13.15. Policies—rate of return risk

An Islamic Bank's rate of return risk management policy:

- (a) must describe the approach to managing an Islamic Bank's rate of return risk and any resulting withdrawal risk or DCR;
- (b) must establish procedures to assess:
  - (i) the behavioural and contractual maturity profiles of IAHs;
  - (ii) the impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for IAHs; and
  - (iii) the effect of the level of an Islamic Bank's dependence on current account holders' funds;
- (c) must state the basis, and procedures, for any decision to give up part or all of its share of profits in favour of IAHs;
- (d) must set an Islamic Bank's risk tolerance for DCR; and



- (e) must include requirements for provisioning, and transfers to and from reserves, in accordance with the agreed contractual terms and conditions for IAHS.

### 13.16. Smoothing techniques

- (1) To mitigate withdrawal risk and DCR, an Islamic bank may use one or more of the following techniques. The objective of smoothing techniques is to satisfy and retain fund providers and dissuade them from withdrawing their funds.
- (2) An Islamic Bank may give up part or all of their *mudarib* share of profits. The decision to give up part or all of its *mudarib* share of profits in favour of IAHS is a commercial decision.
- (3) An Islamic Bank may make unilateral transfers (by means of *hibah*) to IAHS from the shareholders' current or retained profits. Hibah is the unilateral transfer of ownership of a property or its benefit to another without any counter-value from the recipient.
- (4) An Islamic Bank may establish a Profit Equalisation Reserve (or PER) by setting aside amounts from the investment profits, before allocation of share of profits between IAH and an Islamic Bank (for their respective shares in the PSIA pool) and before calculating their *mudarib* share of profits. The PER is to maintain a level of return on investment for IAHS.

#### Guidance

Even before using smoothing techniques, an Islamic bank is encouraged to employ balance sheet techniques to minimise its exposures to rate of return risk. Examples of the strategies that an Islamic Bank might use include:

- (a) determining and varying future profit ratios according to expectations of market conditions
- (b) developing new *Shari'ah*-compliant instruments
- (c) issuing securitisation tranches of *Shari'ah*-permissible assets.

An Islamic bank should develop and maintain an informed judgement about an appropriate level of the balances of its PER. The nature of the reserve implies that there will be years in which the balance of the reserve will be increased, and others in which it will be depleted.

- (5) An Islamic Bank may establish an Investment Risk Reserve (or IRR) by setting aside amounts from the investment profits of IAHS, after allocating PER (if any) and deducting an Islamic Bank's *mudarib* share of profits. The IRR is to cushion against future investment losses for IAHS and must not be used for any other purpose.

### 13.17. Calculating rate of return

- (1) An Islamic bank must use the gapping method to allocate positions into time bands based on remaining maturities or repricing dates.
- (2) Fixed-rate and floating-rate assets of an Islamic Bank must be classified according to their receivable dates because the returns on these receivables represent the IAHS' direct and beneficial ownership of the assets. Actual cash flows may indicate a gap for a particular time band, affecting the rate of return for that period.



- (3) Depending on the nature, scale and complexity of an Islamic Bank's business, an Islamic Bank may employ techniques ranging from simple gap to advance simulation or dynamic approaches to assess future cash flow variability and net income.

**Guidance**

- (1) The estimates derived from selected approaches might provide acceptable approximations of periodic future earnings' variability, and the outcomes would yield different levels of expected returns to IAHS.
- (2) The measurement of rate of return risk highlights the importance of cash flow forecasting for instruments and contracts where the Islamic Bank is required to simulate and assess their behavioural maturity, underlying assumptions and parameters, which should be reviewed periodically for reliability. The significance of potential threats to future earnings and the usefulness of the resulting information should be considered in determining the type and extent of forecasted behaviour for an Islamic Bank.

**13.18. Relation to stress-testing**

When carrying out stress-testing or review of stress scenarios, an Islamic bank must take into account an Islamic Bank's vulnerability to loss under adverse benchmark rate movements.

**13.19. Calculation of capital adequacy ratio—no smoothing**

If an Islamic Bank does not smooth profit payouts to IAHS, an Islamic Bank's capital adequacy ratio is calculated by dividing an Islamic Bank's Regulatory Capital by the amount calculated in accordance with the following formula:

$$(TRC + TRM + TRO) - (PRC + PRM)$$

where:

**TRC** is total risk-weighted assets adjusted for Credit Risk.

**TRM** is total risk-weighted assets adjusted for Market Risk.

**TRO** is total risk-weighted assets adjusted for Operational Risk.

**PRC** is total risk-weighted assets financed by PSIA's, adjusted for Credit Risk.

**PRM** is total risk-weighted assets financed by PSIA's, adjusted for Market Risk.

**Guidance**

If an Islamic bank does not smooth profit payouts to IAHS, an Islamic Bank is not required to hold Regulatory Capital against credit or Market Risks arising from assets funded by the PSIA's. The RWAs funded by such accounts are excluded in respect of those risks in calculating the denominator of an Islamic Bank's CAR, leaving only Operational Risk.

**13.20. Calculation of capital adequacy ratio—smoothing**

If an Islamic bank smooths profit pay-outs to IAHS, an Islamic Bank's capital adequacy ratio is calculated by dividing an Islamic Bank's Regulatory Capital by the amount calculated in accordance with the following formula:

$$(TRC + TRM + TRO) - (PRC^R + PRM^R) - ((1 - \alpha) (PRC^U + PRM^U) - \alpha(PRC^V + PRM^V))$$



where:

$\alpha$  represents the proportion of assets funded by unrestricted PSIAs, and is set at 0.35 by the AFSA.

**TRC** is total risk-weighted assets adjusted for Credit Risk.

**TRM** is total risk-weighted assets adjusted for Market Risk.

**TRO** is total risk-weighted assets adjusted for Operational Risk.

**PRC<sup>R</sup>** is total risk-weighted assets financed by restricted PSIAs, adjusted for Credit Risk

**PRM<sup>R</sup>** is total risk-weighted assets financed by restricted PSIAs, adjusted for Market Risk.

**PRC<sup>U</sup>** is total risk-weighted assets financed by unrestricted PSIAs, adjusted for Credit Risk.

**PRM<sup>U</sup>** is total risk-weighted assets financed by unrestricted PSIAs, adjusted for Market Risk.

**PRC<sup>V</sup>** is total risk-weighted assets financed by the PER and IRR for unrestricted PSIAs, adjusted for Credit Risk.

**PRM<sup>V</sup>** is total risk-weighted assets financed by the PER and IRR for unrestricted PSIAs, adjusted for Market Risk.

### Guidance

If an Islamic bank smooths profit pay-outs to IAHs, an Islamic Bank is required to hold Regulatory Capital against Credit or Market Risks arising from assets funded by the PSIAs, to cater for DCR. In this approach, Credit and Market Risks of assets financed by unrestricted PSIAs are considered to be borne proportionately by both the IAHs and an Islamic Bank. Therefore, a proportion of the RWAs funded by unrestricted PSIAs is required to be included in the denominator of the CAR.



## 14. SUPERVISORY REVIEW AND EVALUATION PROCESS

### Guidance

- (i) This Chapter implements the critical Pillar II of the Basel III framework and the corresponding IFSB Standard 16 implementing Pillar II for Islamic Banking. Pillar II offers an avenue for addressing all the risk exposures faced by an Islamic Bank, which have not been covered in the estimation of Capital Requirements to absorb potential unexpected losses. The rules in this Chapter set out the regulatory requirements for Islamic Banks to carry out a self-assessment of their risks which can be reviewed and assessed by the regulator. This Chapter details the rules stipulating the need for Islamic Banks to complete internal risk assessments followed by an internal capital adequacy assessment process (ICAAP). The AFSA will review the results of the ICAAP. This Chapter also sets out how the AFSA may impose an additional Capital Requirement specifically for individual Islamic Banks in addition to the minimum Capital Requirement specified in Chapter 4.
- (ii) The detailed requirements specifying the methodologies, parameters, and guidance in respect of the ICAAP and supervisory review process requirements for a Bank are provided in Appendix 3 of the IBB. It is suggested that this Chapter be read in conjunction with Appendix 3 of the IBB Module, to facilitate understanding of the regulatory requirements and compliance with them.

### 14.1. Application to a Financial Group

Where an Islamic Bank to which this Chapter applies is part of a Financial Group, this Chapter applies on a consolidated basis in relation to all the entities within the Financial Group.

### 14.2. Internal Capital Adequacy Assessment Process (ICAAP)

- (1) An Islamic Bank must implement and maintain an ICAAP which details the processes and procedures by which the Islamic Bank will assess and maintain adequate capital resources in relation to the risks faced by it.
- (2) The Islamic Bank must conduct an ICAAP assessment at least annually giving due regard to the guidance in Appendix 3 of the IBB Module.
- (3) The ICAAP assessment conducted by the Islamic Bank pursuant to (2) must be approved by its Governing Body and then submitted to the AFSA within four months from the end of the Islamic Bank's financial year.
- (4) In addition to (2), the Islamic Bank must conduct an ICAAP assessment:
  - (a) whenever there is material change to the business, strategy, nature or scale of the activities of the Islamic Bank which may have a significant impact on its risk profile or adequacy of its RC; or
  - (b) as and when required by the AFSA.
- (5) The ICAAP assessment conducted by the Islamic Bank pursuant to (4) must be approved by its Governing Body and then submitted to the AFSA within two months from the date of such material change or requirement.
- (6) An Islamic Bank must ensure that an ICAAP assessment is documented in writing and includes details of:



- (a) the calculations and models used in the determination of the level of Capital Requirements which it considers will be adequate to cover all the risks identified by its ICAAP assessment;
  - (b) the Islamic Bank's strategies and plans to ensure availability of the level of capital determined by the ICAAP;
  - (c) specifications of any models used in the ICAAP, including the underlying assumptions, parameters, and results of back-testing; and
  - (d) any other relevant information, giving due and appropriate regard to the guidance in Appendix 3 of the IBB Module.
- (7) An Islamic Bank must retain the records of an ICAAP assessment for at least six years.

**14.3. Imposition of an Individual Capital Requirement**

- (1) The AFSA may, subject to (3) and (4), at any time by written notice to a Islamic Bank:
  - (a) impose an Individual Capital Requirement; or
  - (b) vary or withdraw an Individual Capital Requirement.
- (2) The AFSA may impose or vary an Individual Capital Requirement by written notice, on its own initiative, where the AFSA forms the view that the Islamic Bank's Capital Requirement is insufficient to address adequately all its risks.
- (3) The AFSA will, in addition to prescribing an Individual Capital Requirement, also specify in the notice the types and amounts of capital resources required to meet the Individual Capital Requirement.
- (4) Any decisions made under this Rule 14.3 will be subject to the decision-making procedures set out in Schedule 1 of the AIFC Financial Services Framework Regulations.
- (5) If the AFSA decides to exercise its power under (2) after a Licence has been granted, the Islamic Bank may refer the matter to the AIFC Court for review.
- (6) An Islamic Bank must have and maintain, at all times, RC as defined in by the rules in Chapter 4 as well as capital meeting the types and amounts specified in the notice issued to it under this rule to meet its Individual Capital Requirement.





## 15. PUBLIC DISCLOSURE REQUIREMENTS

### Guidance

- (i) This Chapter implements the Pillar III of the Basel III framework and the corresponding IFSB Standard 22 on disclosures to promote transparency and market discipline for Islamic Banks. Pillar III is aimed at facilitating market discipline which is considered as one of the effective mechanisms to ensure safety and soundness of banks. This principle has been emphasised by the IFSB by publishing an exclusive standard on disclosure requirements which forms the basis for the requirements set out in this chapter, which include requirements for Islamic Banks to make periodic disclosures of relevant and material information about their business activities and data on risk exposures assumed by them.
- (ii) The detailed requirements specifying the methodologies, parameters, and guidance in respect of the disclosure requirements for an Islamic Bank are provided in Appendix 4 of the IBB Module. It is suggested that this Chapter be read in conjunction with Appendix 4 of the IBB Module, to facilitate understanding of the regulatory requirements and compliance with them.

### 15.1. Disclosure requirement

An Islamic Bank must disclose all relevant data, both qualitative and quantitative data, to completely fulfil all the tables and templates set out in Appendix 4 of IBB Module.

### 15.2. Application to a Financial Group

- (1) An Islamic Bank, which is a member of a Financial Group, according to Chapter 11, must ensure that the detailed disclosures specified in Appendix 4 of the IBB Module are made on a consolidated basis, at the level of the Financial Group.
- (2) An Islamic Bank which is a Subsidiary of a regulated bank or Financial Institution or another Islamic Bank, which is already subject to equivalent public disclosure requirements, does not need to comply with the requirements in this Chapter to the extent that it meets those equivalent public disclosure requirements.

### 15.3. Disclosure policy

- (1) An Islamic Bank must implement and maintain a written disclosure policy that:
  - (a) sets out the Islamic Bank's approach for determining which of the disclosures set out in Appendix 4 of the IBB Module it needs to make;
  - (b) details the processes and procedures and its internal controls in relation to such disclosure details the medium for disclosure that most appropriately meets the purposes of this Chapter; and
  - (c) is approved by the Governing Body of the Islamic Bank.
- (2) An Islamic Bank must ensure that appropriate verification, whether internal or external, is performed in relation to any disclosure, and take all reasonable steps to ensure its accuracy and timeliness.
- (3) To the extent that any required disclosure is substantially similar to a disclosure required of the Islamic Bank under the International Financial Reporting Standards, a disclosure





under such standards must be made to meet the requirement for disclosure under this Chapter.

**15.4. Disclosure frequency, locations and omissions**

- (1) The disclosures set out in this Chapter must be made by the Islamic Bank at least once a year, other than disclosures of CET1 Capital, T1 Capital and T2 Capital, deductions from capital resources, Liquidity Coverage Ratio and Leverage Ratios which must be made on a quarterly basis.
- (2) Reporting deadlines must be in accordance with quarterly and annual reporting obligations under Chapter 3. The required disclosures must be published concurrently with the periodic financial statements of the Islamic Bank.
- (3) In cases where an Islamic Bank does not publish an financial report or statements in the period for which it is required to fulfil a disclosure requirement set out in this rules, the disclosure must then be published as soon as practicable. However, the time lag must not exceed more than 3 months from the end of the reporting period for the specific regulatory requirement.
- (4) An Islamic Bank must, subject to (2), make these disclosures either in its annual report or periodic financial statements.
- (5) An Islamic Bank may disclose the items marked as quantitative in Appendix 4 of the IBB Module in a medium or location other than its annual report or periodic financial statements, provided that:
  - (a) it has prior approval of the AFSA to do so;
  - (b) the annual report or periodic financial statements contain clear references to the location of such disclosures; and
  - (c) such disclosures are readily accessible by the market.
- (6) An Islamic Bank may omit certain disclosures if the omitted item is:
  - (a) not material, in accordance with the concept of materiality under the International Financial Reporting Standards;
  - (b) proprietary in nature, and the disclosure of the relevant information to the public would undermine the Islamic Bank's competitive position or render the Islamic Bank's investments in products and systems less valuable; or
  - (c) confidential in nature, and the disclosure of the relevant information would violate or jeopardise confidentiality agreements with Clients or counterparties.
- (7) Where in reliance upon (5)(b) or (c) above, an Islamic Bank omits an item that is marked as a quantitative disclosure in Appendix 4 of the IBB Module, it must disclose general qualitative information about the subject matter of that particular requirement, together with the reasons for the omission.



## APPENDIX 1: LIQUIDITY RISK

### A. Liquidity Coverage Ratio (LCR)

1. The objective of the LCR is to promote short-term resilience of an Islamic Bank's Liquidity Risk profile. The LCR aims to ensure that an Islamic Bank maintains an adequate level of unencumbered HQLA that can be converted into cash to meet its liquidity needs for a 30 calendar day period under a severe liquidity stress scenario.
2. The purpose of requiring Islamic Banks to maintain the HQLA portfolio and to meet the LCR requirement, is to ensure that Islamic Banks are resilient, in the short term, to Liquidity Risk. The LCR requirement is intended to ensure that an Islamic Bank always holds unencumbered assets that can be readily converted into sufficient cash to meet its liquidity needs for 30 calendar days even under severe liquidity stress.
3. The LCR is calculated under Rule 10.25.
4. The LCR has two components:
  - (a) Value of the stock of HQLA in stressed conditions; and
  - (b) Total Net Cash Outflows, calculated according to the stressed scenario parameters outlined in this section
5. The stress scenario entails both institution-specific and systemic shocks including:
  - (a) the run-off of a proportion of retail deposits;
  - (b) a partial loss of unsecured wholesale funding capacity;
  - (c) a partial loss of secured, short-term financing with certain collateral and counterparties;
  - (d) additional contractual outflows that would arise from a downgrade in the Bank's public credit rating, where applicable, by up to and including three notches, including collateral posting requirements;
  - (e) increases in market volatility that affect the quality of collateral or potential future exposure of derivative positions and so require larger collateral haircuts or additional collateral, or lead to other liquidity needs;
  - (f) unscheduled draws on committed but unused credit and liquidity facilities that the Bank has provided to its clients; and
  - (g) the potential need for the Bank to buy back debt or honour non-contractual obligations to mitigate reputational risk.
6. For the purposes of complying with Rule 10.25, a currency is considered material to an Islamic Bank, if the aggregate liabilities denominated in that currency amount to 5% or more of its total liabilities.

### High Quality Liquid Assets (HQLA)

7. Assets that meet the conditions and requirements specified in the following paragraphs 7 to 15 are eligible to be considered as HQLA. Those assets are considered to be HQLA as they can be converted easily and immediately into cash at little or no loss of value. To qualify as HQLA, assets should be liquid in markets during a time of stress.
8. In determining whether or not the market for an asset can be relied upon to raise liquidity during a time of stress, the following fundamental factors should be taken into account:



- (a) low risk: high credit standing of the issuer and a low degree of subordination, low duration, low legal risk, low inflation risk, denomination in a convertible currency with low foreign exchange risk;
  - (b) ease and certainty of valuation;
  - (c) low correlation with risky assets, not subject to wrong-way risk; and
  - (d) listing on a developed and recognised exchange.
9. In assessing the reliability of a market for raising liquidity during a time of stress, the following market-related characteristics should be taken into account, though not limited to them:
- (a) active and sizable market, including active outright sale or repo markets at all times. This can be demonstrated through:
    - (i) historical evidence of market breadth and market depth (low bid-ask spreads, high trading volumes, large and diverse number of market participants); or
    - (ii) existence of robust market infrastructure (presence of multiple committed market makers);
  - (b) low price volatility, including historical evidence of relative stability of market terms (e.g. prices and haircuts) and volumes during stressed periods; or
  - (c) flight to quality, i.e. that historically the market has shown a tendency to move into these types of high quality assets in a systemic crisis.

#### **HQLA – general operational requirements**

10. To be eligible as HQLA, assets in the portfolio of HQLA must be appropriately diversified in terms of type of assets, type of issuer and specific counterparty or issuer. To be eligible as HQLA, assets must meet the following requirements:
- (a) the assets must be under the control of the specific function or functions charged with managing the liquidity of the Islamic Bank who must have the continuous authority and legal and operational capability to liquidate any asset in the stock; and
  - (b) a representative portion of the assets in the stock of HQLA must be liquidated periodically and at least annually by the Islamic Bank to test its access to the market, the effectiveness of its processes for liquidation, the availability of the assets, and to minimize the risk of negative signaling during a period of actual stress.
11. To be eligible as HQLA, an asset must also meet the following requirements:
- (a) the asset must be unencumbered and free of legal, regulatory, contractual or other restrictions that affect the ability of the Islamic Bank to liquidate, sell, transfer, or assign the asset;
  - (b) the asset must not be pledged, either explicitly or implicitly, to secure, collateralize or credit-enhance any transaction, nor be designated to cover operational costs (such as rents and salaries); and
  - (c) an asset received in a securities financing transaction that is held at the Islamic Bank, is eligible for inclusion in the stock of HQLA only if the asset has not been rehypothecated and is legally and contractually available for the Islamic Bank's use.
12. These requirements in paragraphs above are intended to ensure that the stock of HQLA is managed in such a way that the Islamic Bank can, and is able to demonstrate that it can, immediately use the assets as a source of contingent funds that is available to convert into cash to fill funding gaps between cash inflows and outflows at any time during the 30-day stress period, with no restriction on the use of the liquidity generated. The control of the HQLA may be evidenced



either by:

- (a) maintaining assets in a separate pool managed by the identified liquidity management function (typically the treasurer) with the sole intent to use it as a source of contingent funds; or
  - (b) demonstrating that the relevant function can liquidate the asset at any point in the 30- day stress period and that the proceeds are available to the function throughout the 30- day stress period without directly conflicting with a stated business or risk management strategy.
13. Operational capability to liquidate assets referred to in paragraph 12 above, requires procedures and appropriate systems to be in place. This includes providing the liquidity management function with access to all necessary information to liquidate any asset at any time. Liquidation of the asset should be executable operationally within the standard settlement period for the asset class in the relevant jurisdiction.

#### **Caps on different types of HQLA – calculation of LCR**

14. Assets eligible to be included in the stock of HQLA for the purpose of the LCR calculation are classified under the following two categories:
- (a) Level 1 HQLA, consisting of the highest quality and most liquid assets; and
  - (b) Level 2 HQLA, including Level 2A HQLA and Level 2B HQLA, consisting of other high quality liquid assets.
15. When calculating the total stock of HQLA, an Islamic Bank must apply the following caps in respect of each category of assets:
- (a) Level 1 HQLA can be included in the total stock of HQLA without any limit (i.e. up to 100% of HQLA);
  - (b) Total Level 2 HQLA, including both Level 2A HQLA and Level 2B HQLA, can comprise only up to 40% of the total stock of HQLA; and
  - (c) Level 2B HQLA can comprise only up to 15% of the total stock of HQLA within the overall 40% limit on Level 2 HQLA in (b).
16. The caps on Level 2 HQLA and Level 2B HQLA must be determined after applying the haircuts required to cover currency mismatches, and after unwinding the amounts of HQLA involved in short-term secured funding, secured financing and collateral swap transactions maturing within 30 calendar days that involve the exchange of HQLA. The assets to be included in each category of HQLA must be restricted to assets being held or owned by the Islamic Bank on the first day of the stress period, irrespective of their residual maturity.
17. The following paragraphs illustrate how the caps on various types of HQLA, as specified in paragraphs 14 & 15 are to be applied in practice, for the calculation of LCR. The adjusted amounts of HQLA should be calculated as the amount of HQLA that would result after unwinding those short-term secured funding, secured financing and collateral swap transactions that involve the exchange of any HQLA for any other HQLA. The calculation of the stock of HQLA for paragraph 15 can be expressed as the following formula:

**Stock of HQLA = Level 1 HQLA + Level 2A HQLA + Level 2B HQLA – Adjustment for 15% cap – Adjustment for 40% cap**

Where:

- (a) Adjustment for 15% cap =  $\text{Max (Adjusted Level 2B HQLA – } 15/85 \times (\text{Adjusted$



- Level 1 HQLA + Level 2A HQLA), Adjusted Level 2B  
HQLA - 15/60 x (Adjusted Level 1 HQLA, 0)
- (b) Adjustment for 40% cap =  $\text{Max } ((\text{Adjusted Level 2A HQLA} + \text{Adjusted Level 2B HQLA} - \text{Adjustment for 15\% cap}) - 2/3 \times \text{Adjusted Level 1 HQLA}, 0)$

### Level 1 HQLA

18. Level 1 HQLA must be valued at market value and it consists of:

- (a) banknotes and coin;
- (b) central bank reserves, to the extent that such reserves are capable of being drawn down immediately in times of stress
- (c) marketable Islamic securities representing claims on or claims guaranteed by sovereigns, central banks, Public Sector Entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Commission or Multilateral Development Banks (MDBs), and that satisfy all of the following conditions:
  - (i) they are assigned a zero % risk-weight according to Chapter 4 and App4 of this Module;
  - (ii) they are traded in large, deep and active repo or cash markets characterised by a low level of concentration
  - (iii) they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions; and
  - (iv) they are not an obligation of a financial institution or any of its associated entities
- (d) in the case of sovereigns that are not eligible for zero % risk-weight, sovereign or central bank *sukuk* or *sukuk* issued in domestic currencies by the sovereign or central bank in the country in which the Liquidity Risk is being taken or in the Islamic Bank's home jurisdiction, where those securities satisfy all of the conditions in paragraph (c) (ii)(iii) and (iv) above;
- (e) in the case of sovereigns that are not eligible for zero % risk-weight, domestic sovereign or central bank *Sukuk* issued in foreign currencies, up to the amount of the Islamic Bank's stressed net cash outflows in that specific foreign currency stemming from the Islamic Bank's operations in the jurisdiction where the Islamic Bank's Liquidity Risk is being taken, where those securities satisfy all of the conditions in paragraph (c) (ii)(iii) and (iv) above; and
- (f) any other types of assets approved by the AFSA under paragraph 21 of this appendix as being eligible to be Level 1 HQLA.

### Level 2A HQLA

19. Level 2A HQLA must be valued at market value and subject to a 15% haircut and it consists of:

- (a) marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or MDBs that satisfy all of the following conditions:
  - (i) they are assigned a 20% risk-weight according to Chapter 6 of IBB Module;
  - (ii) they are traded in large, deep and active repo or cash markets characterised by a low level of concentration;
  - (iii) they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%); and



- (iv) they are not an obligation of a financial institution or any of its associated entities.
- (b) corporate *sukuk* (including commercial paper) that satisfy all of the following conditions:
  - (i) in the case of corporate *sukuk*: they must not be issued by a financial institution or any of its associated entities and must include only plain vanilla assets (i.e. not include complex structured products or subordinated debt) whose valuation is readily available based on standard methods and does not depend on private knowledge;
  - (ii) in the case of covered *sukuk*: they must not be issued by the Islamic Bank itself or any of its associated entities
  - (iii) the assets must have a Credit Quality Grade of 1 from a recognised ECAI or, if the assets do not have a credit assessment by a recognised ECAI, they must be internally rated as having a probability of default (PD) corresponding to a Credit Quality Grade of 1;
  - (iv) they must be traded in large, deep and active repo or cash markets characterised by a low level of concentration; and
  - (v) they must have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 10%); and
- (c) any other types of assets approved by the AFSA under paragraph 21 as being eligible to be Level 2A HQLA.

#### Level 2B HQLA

20. Level 2B HQLA must be valued at market value and subject to an appropriate haircut, as specified in (2), for each type of asset and it consists of:

- (a) residential financing backed securities that satisfy all of the following conditions, subject to a 25% haircut:
  - (i) they are not issued by, and the underlying assets have not been originated by, the Islamic Bank itself or any of its affiliated entities;
  - (ii) they have a Credit Quality Grade of 1 from a recognised ECAI;
  - (iii) they are traded in large, deep and active repo or cash markets characterised by a low level of concentration;
  - (iv) they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 20%);
  - (v) the underlying asset pool is restricted to residential financings and does not contain structured products;
  - (vi) the underlying residential financings are “full recourse” financings (i.e. in the case of foreclosure the financing owner remains liable for any shortfall in sales proceeds from the property) and have a maximum financing-to- value ratio (FTV) of 80% on average at issuance; and
  - (vii) the securitisations are subject to “risk retention” regulations which require issuers to retain an interest in the assets they securitise;
- (b) corporate *sukuk* (including commercial paper) that satisfy all of the following conditions, subject to a 50% haircut:





- (i) they are not issued by a financial institution or any of its affiliated entities;
  - (ii) they have a Credit Quality Grade of 2 or 3 from a recognised ECAI or, in the case the assets do not have a credit assessment by a recognised ECAI, are internally rated as having a probability of default (PD) corresponding to a Credit Quality Grade of 2 or 3;
  - (iii) they are traded in large, deep and active repo or cash markets characterised by a low level of concentration; and
  - (iv) they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 20%);
- (c) equity shares that satisfy all of the following conditions, subject to a 50% haircut:
- (i) they are not issued by a financial institution or any of its affiliated entities;
  - (ii) they are exchange traded and centrally cleared;
  - (iii) they are a constituent of the major stock index in the home jurisdiction, or where the Liquidity Risk is taken, as decided by the supervisor in the jurisdiction where the index is located;
  - (iv) they are denominated in the domestic currency of an Islamic Bank's home jurisdiction or in the currency of the jurisdiction where the Islamic Bank's Liquidity Risk is taken;
  - (v) they are traded in large, deep and active repo or cash markets characterised by a low level of concentration; and
  - (vi) they have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, (i.e. maximum decline of price or increase in haircut over a 30-day period during a relevant period of significant liquidity stress not exceeding 40%); and
- (d) any other types of assets approved by the AFSA under paragraph 21 as being eligible to be Level 2B HQLA.

### **Approval of other types of HQLA**

21. The AFSA may approve other types of assets as being eligible to be included in the stock of HQLA for the purposes of the calculation of the LCR. In such cases, the AFSA will also specify whether they are to be classified as Level 1 HQLA or Level 2 HQLA and the haircut, if any, to be applied to them. In such cases, the AFSA may also define the conditions that the assets must satisfy to be treated as HQLA.

### **Other provisions relating to LCR calculation**

22. For the purpose of calculating the LCR, if an eligible asset within HQLA becomes ineligible (e.g. due to a rating downgrade), an Islamic Bank is allowed to keep the asset in its stock of HQLA for an additional 30 calendar days to allow time to adjust its stock as needed or replace the asset.
23. For the purpose of calculating a consolidated LCR for a Financial Group, where applicable, qualifying HQLA held to meet statutory liquidity requirements at a legal entity or sub-consolidated level may be included in the stock at the consolidated level only to the extent that the related risks are also reflected in the consolidated LCR. Any surplus of HQLA held at the legal entity can be included in the consolidated stock of HQLA only if those assets would also be freely available to the consolidated parent entity in times of stress.
24. An Islamic Bank must be able to meet its liquidity needs in each currency in which it has a material exposure. The currencies of the stock of HQLA of an Islamic Bank must be similar in composition to its liquidity needs by currency.



## Total Net Cash Outflow

25. An Islamic Bank must calculate its Total Net Cash Outflow over the following 30 calendar days in accordance with the following formula:

Total Net Cash Outflows over the next 30 calendar days

= total expected cash outflows – whichever is the lesser amount of total expected cash inflows or 75% of total expected cash outflows

26. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities and off-balance commitments by the rates at which they are expected to run off or be drawn down.
27. Total expected cash inflows are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in. To ensure a minimum level of HQLA holdings at all times, total cash inflows are subject to an aggregate cap of 75% of total expected cash outflows.
28. A Bank must not double-count items. That is, for assets included as part of the eligible stock of HQLA, the associated cash inflows arising from such assets must not be counted as cash inflows for the purpose of calculating the net cash outflows over the next 30 calendar days.

## Cash Outflows

29. The following table specifies, for each of the various categories or types of liabilities and off-balance sheet commitments, the rates at which they are expected to run off or be drawn down for the purpose of calculating the LCR.

**Table 10 A - Cash Outflows**

Item	Factor
<b>A. Retail Deposits:</b>	
Demand deposit and term deposits (less than 30 days maturity):	
• Stable deposits	5%
• Less stable retail deposits	10%
Term deposits with residual maturity greater than 30 days	0%
<b>B. Unsecured Wholesale Funding:</b>	
Demand and term deposits (less than 30 days maturity) provided by small business customers:	
• Stable deposits	5%
• Less stable deposits	10%





Small business customers - Term deposits with residual maturity greater than 30 days with no legal right to withdraw or a withdrawal with a significant penalty	0%
Operational deposits generated by clearing, custody and cash management activities:	25%
<ul style="list-style-type: none"> <li>• Portion covered by deposit insurance</li> </ul>	5%
Cooperative banks in an institutional network (qualifying deposits with the centralized institution)	25%
Non-financial corporates, sovereigns, central banks, multilateral development banks and PSEs:	40%
<ul style="list-style-type: none"> <li>• If the entire amount is fully covered by a deposit protection scheme</li> </ul>	20%
Other legal entity customers	100%
<b>C. Secured Funding:</b>	
<ul style="list-style-type: none"> <li>• Secured funding transactions with a central bank counterparty or backed by Level 1 HQLA with any counterparty</li> </ul>	0%
<ul style="list-style-type: none"> <li>• Secured funding transactions backed by Level 2A HQLA, with any counterparty</li> </ul>	15%
<ul style="list-style-type: none"> <li>• Secured funding transactions backed by non-Level 1 HQLA or non-Level 2A HQLA, with domestic sovereigns, multilateral development banks, or domestic PSEs as a counterparty</li> </ul>	25%
<ul style="list-style-type: none"> <li>• Backed by RMBS eligible for inclusion in Level 2B HQLA</li> </ul>	25%
<ul style="list-style-type: none"> <li>• Backed by other Level 2B HQLA</li> </ul>	50%
<ul style="list-style-type: none"> <li>• All other secured funding transactions</li> </ul>	100%
<b>D. Additional Requirements:</b>	
Derivatives cash outflows	100%
Liquidity needs (e.g. collateral calls) related to financing transactions, derivatives and other contracts	100%
Market valuation changes on non-Level 1 HQLA posted collateral securing derivatives	20%



Excess collateral held by an Islamic bank related to derivative transactions that could contractually be called at any time by its counterparty	100%
Liquidity needs related to collateral contractually due from the reporting bank on derivatives transactions	100%
Increased liquidity needs related to derivative transactions that allow collateral substitution to non-HQLA assets	100%
Market valuation changes on derivatives transactions (largest absolute net 30-day collateral flows realised during the preceding 24 months)	100%
ABCP, SIVs, Conduits, etc:	
<ul style="list-style-type: none"> <li>• Loss of funding on Asset Backed Securities, covered bonds and other structured financing instruments</li> </ul>	100%
<ul style="list-style-type: none"> <li>• Loss of funding on ABCP, SIVs, SPVs, etc</li> </ul>	100%
Undrawn committed credit and liquidity facilities:	
<ul style="list-style-type: none"> <li>• Credit and Liquidity Facilities: Retail and small and medium-sized enterprise clients</li> </ul>	5%
<ul style="list-style-type: none"> <li>• Credit Facilities: Non-financial corporates, sovereigns and central banks, PSEs, MDBs</li> </ul>	10%
<ul style="list-style-type: none"> <li>• Liquidity Facilities: Non-financial corporates, sovereigns and central banks, PSEs, MDBs</li> </ul>	30%
<ul style="list-style-type: none"> <li>• Credit and Liquidity Facilities: Banks subject to prudential supervision</li> </ul>	40%
<ul style="list-style-type: none"> <li>• Credit Facilities: Other financial institutions (include securities firms, insurance companies, Takaful &amp; Retakaful entities, fiduciaries and beneficiaries)</li> </ul>	40%
<ul style="list-style-type: none"> <li>• Liquidity Facilities: Other financial institutions (include securities firms, insurance companies, Takaful &amp; Retakaful entities, fiduciaries and beneficiaries)</li> </ul>	100%
<ul style="list-style-type: none"> <li>• Credit and Liquidity Facilities: Other legal entity customers</li> </ul>	100%
<ul style="list-style-type: none"> <li>• Other contractual obligations to financial institutions</li> </ul>	100%
<ul style="list-style-type: none"> <li>• Other contractual obligations to retail and non-financial corporate clients</li> </ul>	100%
Other contingent funding obligations:	
<ul style="list-style-type: none"> <li>• Non-contractual obligations related to potential liquidity draws from joint ventures or minority investments in entities</li> </ul>	100%



• Trade finance-related obligations (including letters of credit and guarantees)	5%
• Unconditionally revocable "uncommitted" credit and liquidity facilities	5%
• Guarantees and letters of credit unrelated to trade finance obligations	10%
Non-contractual obligations:	
• Debt-buy back requests (incl. related conduits)	20%
• Structured products	10%
• <i>Shari'ah</i> -compliant Managed funds	10%
• Other non-contractual obligations	100%
Outstanding <i>sukuk</i> with remaining maturity > 30 days	100%
Non contractual obligations where customer short positions are covered by other customers' collateral	50%
Other contractual cash outflows	100%

30. The following paragraphs set out the AFSA's views about how the table above defining the treatment of various cash outflows should be applied to different items.

### Retail Deposits

31. Retail deposits should include deposits from individuals placed with an Islamic Bank. Deposits from legal entities, sole proprietorships or partnerships should be included in wholesale deposit categories. Deposits may include demand deposits and term deposits, unless otherwise excluded. Deposits from individuals are divided under the Table into 'stable' and 'less stable' deposits. Stable deposits should include the portion of deposits that are fully covered by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection and where:
- the depositor has other established relationships with the Bank that make deposit withdrawal highly unlikely; or
  - the deposits are in transactional accounts (e.g. accounts where salaries are automatically credited).
32. If an Islamic Bank is not able to readily identify which retail deposits would qualify as "stable", it should place the full amount in the "less stable" buckets. Less stable deposits should consist of the portion of deposits that do not meet the conditions in paragraph 34 above and also include types of deposits more likely to be withdrawn in a time of stress. These should include high-value deposits (i.e. deposits above any deposit insurance limit), deposits from customers who do not have established relationships with a Bank that make the deposit withdrawal unlikely, deposits from sophisticated or high net worth individuals, deposits where the internet is integral to the design, marketing and use of the account (on-line accounts) and deposits with promotional interest rates (i.e. that are heavily rate-driven).
33. Cash outflows related to retail term deposits with a residual maturity or withdrawal notice period of greater than 30 days should be excluded from total expected cash outflows only if the depositor



has no legal right to withdraw deposits within the 30-day period of the LCR, or if early withdrawal results in a significant penalty that is materially greater than the loss of interest. If a Bank allows a depositor to withdraw such deposits despite a clause that says the depositor has no legal right to withdraw, the entire category of these funds should be treated as demand deposits.

34. Unsecured wholesale funding should consist of liabilities and general obligations raised from non-natural persons (i.e. legal entities, including sole proprietorships and partnerships) and not collateralised by legal rights to specifically designated assets owned by the Islamic Bank accepting the deposit in the case of bankruptcy, insolvency, liquidation or resolution. Obligations related to derivative contracts should be excluded from this category.
35. Unsecured wholesale funding provided by non-financial corporates and sovereigns, central banks, MDBs, and public sector enterprises comprises all deposits and other extensions of unsecured funding (other than those specifically for operational purposes) from:
  - (a) non-financial corporate customers (except small business customers); and
  - (b) domestic and foreign customers that are sovereigns, central banks, MDBs and public sector enterprises.
36. Unsecured wholesale funding provided by other legal entity customers consists of deposits and other funding (other than operational deposits) which do not qualify as Operational Deposits as defined in this Chapter, such as funding provided by:
  - (a) another financial institution; or
  - (b) a related party of the Bank.
37. All *sukuk* issued by the Islamic Bank are to be treated as unsecured wholesale funding provided by other legal entity customers regardless of the holder. However, securities that are sold exclusively in the retail market and held in retail accounts (or small business customer accounts) may be treated in the appropriate retail or small business customer deposit category. For securities to be treated in that way, there must be limitations preventing them being bought and held other than by retail or small business customers.
38. The wholesale funding included in the LCR should consist of all funding that is callable within the LCR's period of 30 days or that has its earliest possible contractual maturity date within this period (such as maturing term deposits and unsecured *sukuk*), as well as funding with an undetermined maturity. This should include all funding with options that are exercisable at the investor's discretion within the 30-day period.
39. Wholesale funding that is callable by the funds provider subject to a contractually defined and binding notice period longer than the 30-day period should not be included. Unsecured wholesale funding provided by small and medium-sized enterprise customers should be treated as deposits from individuals where:
  - (a) the deposits and other extensions of funds made by non-financial small and medium-sized enterprise customers are managed as retail accounts and are generally considered as having similar Liquidity Risk characteristics to retail accounts; and
  - (b) the total aggregated funding raised from a small and medium-sized enterprise customer is less than USD 1 million (on a consolidated basis where applicable).

### **Operational deposits**

40. Operational deposits should consist of those deposits where customers place, or leave, deposits with a Bank to facilitate their access and ability to use payment and settlement systems and otherwise make payments. Balances can be included only if the customer has a substantive



dependency on the Bank and the deposit is required for such activities. This condition would not be met if the Bank is aware that the customer has adequate back-up arrangements.

41. Qualifying activities in this context refer to clearing, custody or cash management activities where the customer is reliant on the Islamic Bank to perform these services as an independent third-party intermediary in order to fulfil its normal banking activities over the next 30 days. These services should be provided to institutional customers under a legally binding agreement and the termination of such agreements should be subject either to a notice period of at least 30 days or to significant switching costs to be borne by the customer if the operational deposits are moved before 30 days.
42. Eligible operational accounts and the funds in those accounts generated by such an activity should consist of deposits which are:
  - (a) by-products of the underlying services provided by the Islamic Bank;
  - (b) not offered by the Islamic Bank in the wholesale market in the sole interest of offering interest income; and
  - (c) held in specifically designated accounts and priced without giving an economic incentive to the customer to leave excess funds on these accounts.
43. Any excess balances that could be withdrawn without jeopardising these clearing, custody or cash management activities should not qualify as operational accounts. The Islamic Bank must determine how to identify such excess balances. If the Islamic Bank is unable to identify how much of a deposit is an excess balance, the Islamic Bank must assume that the entire deposit is excess and therefore not operational.
44. The identification should be sufficiently granular to adequately assess the risk of withdrawal in an idiosyncratic stress situation. The method should take into account relevant factors such as the likelihood that wholesale customers have above-average balances in advance of specific payment needs, and should consider appropriate indicators (for example, ratios of account balances to payment or settlement volumes or to assets under custody) to identify customers that are not actively managing account balances efficiently.
45. The following paragraphs provide some guidance on the type of services that may give rise to operational deposits.
46. Clearing is a service that enables customers to transfer funds (or securities) indirectly through direct participants in domestic settlement systems to final recipients. Such services are limited to the following activities:
  - (a) transmission, reconciliation and confirmation of payment orders
  - (b) daylight overdraft, overnight financing and maintenance of post-settlement balances
  - (c) determination of intra-day and final settlement positions.
47. Custody is the provision of safekeeping, reporting and processing of assets, or the facilitation of the operational and administrative elements of related activities on behalf of customers in the process of their transacting and retaining financial assets. Such services are limited to the settlement of securities transactions, the transfer of contractual payments, the processing of collateral, and the provision of custody-related cash management services. Custody also includes the receipt of dividends and other income and client subscriptions and redemptions, and extends to asset and corporate trust servicing, treasury, escrow, funds transfer, stock transfer and agency services, (including payment and settlement services, but not correspondent banking), and depository receipts.
48. Cash management is the provision of cash management and related services to customers—that is, services provided to a customer to manage its cash flows, assets and liabilities, and conduct



financial transactions necessary to its operations. Such services are limited to payment remittance, collection and aggregation of funds, payroll administration, and control over the disbursement of funds.

49. Correspondent banking is an arrangement under which a bank holds deposits owned by other banks, and provides payment and other services to settle foreign currency transactions. A deposit that arises out of correspondent banking, or from the provision of prime brokerage services, should not be treated as an operational deposit. Prime brokerage services is a package of services offered to large active investors, particularly institutional hedge funds. The services usually include:
- (a) clearing, settlement and custody
  - (b) consolidated reporting
  - (c) financing (margin, repo or synthetic)
  - (d) securities financing
  - (e) capital introduction
  - (f) risk analytics.
50. Customers' cash balances arising from the provision of prime brokerage services must be treated as separate from any balances required to be segregated under a statutory client protection regime, and must not be netted against other customer exposures. Such offsetting balances held in segregated accounts are to be treated as inflows and must not be counted as HQLA. Any part of an operational account that is fully covered by deposit protection arrangements or other safety nets, may be treated as a stable retail funds.
51. An institutional network of cooperative banks is a group of legally separate banks with a statutory framework of cooperation with a common strategic focus and brand, in which certain functions are performed by a central institution or a specialised service provider. A qualifying deposit is a deposit by a member institution with the central institution or specialised central service provider:
- (a) because of statutory minimum deposit requirements; or
  - (b) in the context of common task-sharing and legal, statutory or contractual arrangements (but only if both the investment account holder and the Islamic bank that receives the deposit participate in the network's scheme of mutual protection against illiquidity and insolvency).
52. The following are not eligible deposits:
- (a) Funds resulting from correspondent banking activities;
  - (b) funds placed at the central institution or a specialised service provider for any reason other than those defined as eligibility requirements for Qualifying Deposits in paragraph 57 above;
  - (c) funds for the operational purposes of clearing, custody, or cash management.

### **Liquidity facilities**

53. A liquidity facility should consist of any committed, undrawn back-up facility that would be used to refinance the debt obligations of a customer in situations where such a customer is unable to roll over that debt in financial markets. The amount of any commitment to be treated as a liquidity facility should consist of the amount of the outstanding debt issued by the customer (or proportionate share of a syndicated facility) maturing within a 30-day period that is backstopped by the facility. Any additional capacity of the facility should be treated as a committed credit facility. General working capital facilities for corporate entities (e.g. revolving credit facilities in place for general corporate or working capital purposes) should not be classified as liquidity facilities, but as credit facilities.
54. Notwithstanding paragraph 53 above, any facilities provided to hedge funds, money market funds





and special purpose funding vehicles, or other vehicles used to finance an Islamic Bank's own assets, should be captured in their entirety as a liquidity facility to a financial institution.

### **Treatment of deposits pledged as security**

55. If a deposit is pledged as security for a financing facility:
- (a) the facility will not mature or be settled within the relevant 30-calendar-day period; and
  - (b) the pledge is subject to a legally enforceable contract under which the deposit cannot be withdrawn before the facility is fully settled or repaid.
56. If no part of the facility has been drawn, the runoff rate is the higher of:
- (a) the rate specified in Table 9A, that would apply to secured or unsecured funding, as the case maybe; and
  - (b) a rate equal to the rate applicable to Undrawn committed credit and liquidity facilities specified in Table 9 A.
57. However, if some part of the facility has been drawn, only that part of the deposit in excess of the outstanding balance of the facility is to be counted. The applicable runoff rate is the rate that applies to secured or unsecured funding, as the case maybe.

### **Treatment of maturing secured funding**

58. The runoff rates for secured funding that matures within the relevant 30-calendar-day period are as set out in table 9A. Secured funding is an Islamic Bank's liabilities and general obligations collateralised by the grant of legal rights to specific assets owned by the Islamic Bank. This scenario assumes that the Islamic Bank has lost its secured funding on short-term financing transactions. In this scenario, the Islamic Bank could continue to transact securities financing transactions only if the transactions were backed by HQLA or were with its domestic sovereign, public sector enterprise or central bank.
59. Collateral swaps, and any other transactions of a similar form, are to be treated as repo or reverse repo agreements. Collateral lent to the Islamic Bank's customers to effect short positions is to be treated as secured funding. The Islamic Bank must apply the factors to all outstanding secured funding transactions with maturities within 30 calendar days, including customer short positions that do not have a specified contractual maturity. The amount of outflow is the amount of funds raised through the transaction, and not the value of the underlying collateral.

### **Treatment of net derivative cash outflows**

60. As specified in Table 9A, the runoff rate for net derivative cash outflows is 100%. The Islamic Bank must calculate those outflows in accordance with its usual valuation methods. The outflows may be calculated on a net basis by counterparty (that is, inflows offsetting outflows) only if a valid master netting agreement exists. From the calculation, the Islamic Bank must exclude liquidity needs that would result from increased collateral needs because of falls in the value of collateral lodged or market value movements. The Islamic Bank must assume that an option will be exercised if it is in the money.
61. If derivative payments are collateralised by HQLA, the cash outflows are to be calculated net of any corresponding cash or collateral inflows that would result, all other things being equal, from contractual obligations to lodge cash or collateral with the Islamic Bank. However, this condition applies only if, after the collateral were received, the Islamic Bank would be legally entitled and operationally able to re- hypothecate it.



62. The runoff rate for increased liquidity needs related to market valuation changes on derivative instruments is 100% of the largest absolute net collateral flow (based on both realised outflows and inflows) in a 30-calendar-day period during the previous 24 months. Market practice requires collateralisation of mark-to-market exposures on derivative instruments. Islamic Banks are likely to face potentially substantial Liquidity Risk exposures to changes in the market valuation of such instruments. Inflows and outflows of transactions executed under the same master netting agreement may be treated on a net basis.

#### **Elevated liquidity needs related to downgrade triggers**

63. The runoff rate for increased liquidity needs related to downgrade triggers in financing transactions, derivatives and other contracts is 100% of the amount of collateral that the Bank would be required to lodge for, or the contractual cash outflow associated with, any downgrade up to and including a 3-notch downgrade. A downgrade trigger is a contractual condition that requires a Bank to lodge additional collateral, draw down a contingent facility or repay existing liabilities early if an ECRA downgrades the Bank. Contracts governing derivatives and other transactions often have such conditions. The scenario therefore requires a Bank to assume that for each contract that contains downgrade triggers, 100% of the additional collateral or cash outflow will have to be lodged for a downgrade up to and including a 3-notch downgrade of the Islamic Bank's long-term credit rating. The Islamic Bank must assume that a downgrade trigger linked to the Islamic Bank's short-term rating will be triggered at the corresponding long-term rating.

#### **Increased liquidity needs related to collateral**

64. The runoff rate for increased liquidity needs related to possible valuation changes on collateral lodged by an Islamic Bank to secure derivatives and other transactions is 20% of the value of any lodged collateral that is not level 1 HQLA (net of collateral received on a counterparty basis, if the collateral received is not subject to restrictions on re-use or re-hypothecation). Most counterparties to derivative transactions are required to secure the mark-to-market valuation of their positions. If level 1 HQLA are lodged as collateral, no additional stock of HQLA need be maintained for possible valuation changes. However, if the Islamic Bank secures such an exposure with other collateral, 20% of the value of such lodged collateral will be added to its required stock of HQLA to cover the possible loss of market value on the collateral.
65. The runoff rate for increased liquidity needs related to excess non-segregated collateral that is held by an Islamic Bank, and could contractually be recalled at any time by a counterparty, is 100% of the value of the excess collateral.
66. The runoff rate for increased liquidity needs related to contractually-required collateral, due from an Islamic Bank on transactions for which the counterparty has not yet demanded that the collateral be lodged, is 100% of the value of the collateral that is contractually due. This run-off rate applies to the following kinds of transaction:
- (a) transactions where:
    - (i) an Islamic Bank holds HQLA collateral;
    - (ii) the counterparty has the right to substitute non-HQLA collateral for some or all of the HQLA collateral without the Bank's consent; and
    - (iii) the collateral is not segregated;
  - (b) transactions where:
    - (i) an Islamic Bank has the right to receive HQLA collateral;
    - (ii) the counterparty has the right to deliver non-HQLA collateral instead of some or all of the HQLA collateral without the Bank's consent; and





- (iii) the collateral is not segregated.
67. The runoff rate for increased liquidity needs related to such a transaction is 100% of the value of HQLA collateral for which non-HQLA collateral can be substituted or delivered, as the case requires.

#### **Treatment of loss of funding on structured finance transactions**

68. The runoff rate for loss of funding on asset-backed securities and other structured financing instruments that mature within the relevant 30- calendar-day period is 100% of the maturing amount. The scenario assumes that there is no refinancing market for the maturing instruments.
69. The runoff rate for loss of funding on asset-backed commercial paper, conduits, structured investment vehicles and other similar financing arrangements that mature within the relevant 30- calendar-day period is 100% of the total of:
- (a) the maturing amount;
  - (b) if the arrangement allows assets to be returned within that period— the value of the returnable assets; and
  - (c) if under the arrangement the Islamic Bank could be obliged to provide liquidity within that period—the total amount of liquidity that the Islamic Bank could be obliged to provide.
70. Islamic Banks that use asset-backed commercial paper, conduits, structured investment vehicles and other similar financing arrangements should fully consider the associated Liquidity Risk. The risks include being unable to refinance maturing debt or derivatives or derivative-like components that would allow the return of assets, or require the Islamic Bank to provide liquidity, within the 30- calendar-day period.
71. If the Islamic Bank's structured financing activities are carried out through a special purpose entity (such as a conduit or structured investment vehicle), the Islamic Bank should, in determining its HQLA requirements, look through to the maturity of the debt instruments issued by the entity and any embedded options in financing arrangements that could trigger the return of assets or the need for liquidity, regardless of whether the entity is consolidated.

#### **Committed credit and liquidity facilities**

72. The runoff rates for drawdowns on committed credit and liquidity facilities are set out in table 9A. A credit facility is a contractual agreement or obligation to extend funds in the future to a retail or wholesale counterparty. For this Rule, a facility that is unconditionally revocable is not a credit facility. Unconditionally revocable facilities (in particular, those without a precondition of a material change in the borrower's credit condition) are included in Contingent funding obligations. A liquidity facility is an irrevocable, undrawn credit facility that would be used to refinance the debt obligations of a customer if the customer were unable to roll over the obligations in financial markets. General working capital facilities for corporate borrowers (for example, revolving credit facilities for general corporate or working capital purposes) are to be treated as credit facilities.
73. For a facility, the relevant runoff rate is to be applied to the undrawn part of it. The undrawn portion of a credit or liquidity facility is to be calculated net of any HQLA lodged or to be lodged as collateral if:
- (a) the HQLA have already been lodged, or the counterparty is contractually required to lodge them when drawing down the facility;
  - (b) the Bank is legally entitled and operationally able to re-hypothecate the collateral in new cash-raising transactions once the facility is drawn down; and
  - (c) there is no undue correlation between the probability of drawing down the facility and the



market value of the collateral.

74. An Islamic Bank may net the collateral against the outstanding amount of the facility to the extent that the collateral is not already counted in the Bank's HQLA portfolio. The amount of a liquidity facility is to be taken as the amount of outstanding debt issued by the customer concerned (or a proportionate share of a syndicated facility) that matures within the relevant 30-calendar-day period and is backstopped by the facility. Any additional capacity of the facility is to be treated as a committed credit facility. The Islamic Bank must treat a facility provided to a hedge fund, money market fund or special purpose entity, or an entity used to finance its own assets, in its entirety as a liquidity facility to a financial institution.

#### **Other contractual obligations to extend funds within 30 calendar days**

75. The runoff rate for other contractual obligations to extend funds within 30 calendar days is 100%. Other contractual obligations to extend funds within 30 calendar days covers all contractual obligations to extend funds within 30 calendar days that do not fall within any of the categories referred above in this section or in Table A. The runoff rate of 100% is to be applied to:
- (a) for obligations owed to financial institutions—the whole amount of such obligations; and
  - (b) for obligations owed to customers that are not financial institutions—the difference between:
    - (i) the total amount of the obligations; and
    - (ii) 50% of the contractual inflows from those customers over the relevant 30-calendar-day period.
76. The runoff rates for other contingent funding obligations are as set out in table 9A. Contingent funding obligations covers obligations arising from guarantees, letters of credit, unconditionally revocable credit and liquidity facilities, outstanding *sukuk* with remaining maturity of more than 30 calendar days, and trade finance. It also covers non-contractual obligations, including obligations arising from any of the following:
- (a) potential liquidity draws from joint ventures or minority investments in entities;
  - (b) debt-buy-back requests (including related conduits);
  - (c) structured products;
  - (d) managed funds;
  - (e) the use of customers' collateral to cover other customers' short positions.
77. Trade finance means trade-related obligations directly related to the movement of goods or the provision of services, such as the following:
- (a) documentary trade letters of credit, documentary collection and clean collection, import bills, and export bills;
  - (b) guarantees directly related to trade finance obligations, such as shipping guarantees.
78. However, financing commitments, such as direct import or export financing for non-financial corporate entities, are to be treated as committed credit facilities. The runoff rate to be applied to other contractual cash outflows is 100%. Other contractual cash outflows includes outflows to cover unsecured collateral borrowings and uncovered short positions, and outflows to cover dividends and contractual interest payments, but does not include outflows related to operating costs.

#### **Cash Inflows**

79. When considering its available cash inflows, an Islamic Bank may include contractual inflows from outstanding exposures only if they are fully performing and there is no reasonable basis to expect



- a default within the 30-day period. Contingent inflows are not included in total net cash inflows. Where an Islamic Bank is overly reliant on cash inflows from one or a limited number of wholesale counterparties, the AFSA may set an alternative limit on the level of cash inflows that can be included in the LCR.
80. The AFSA may allow an Islamic Bank to recognise as cash inflow, access to a parent entity's funds via a committed funding facility if it is a Subsidiary of a foreign bank. In such instances, the committed funding facility from the parent entity must meet both of the following criteria:
- the facility must be an irrevocable commitment and must be appropriately documented; and
  - the facility must be quantified.
81. A committed funding facility from a parent entity referred to in paragraph 80 above, can be recognised as a cash inflow only from day 16 of the LCR scenario. The cash inflow from a parent entity can be sufficient in size to cover only net cash outflows against items with a maturity or next call date between days 16 and 30 of the LCR.
82. Total expected cash inflow over a period is calculated by, for each contractual cash inflow over the period, multiplying it by the applicable rate of inflows (giving the adjusted inflow), and then taking the total of all the adjusted inflows over the period. The following table 10 B specifies, for each of the various categories and types of contractual receivables, the rates at which they are expected to flow in for the purpose of the calculation of the LCR:

**Table 10 B - Cash Inflows**

Item	Factor
<b>Maturing secured financing (incl. <i>Shari'ah</i>-compliant reverse repos and securities borrowing), backed by the following as collateral:</b>	
• Level 1 HQLA	0%
• Level 2A HQLA	15%
• Level 2B HQLA - eligible RMBS	25%
• Level 2B HQLA - Other assets	50%
• Margin financing backed by all other collateral	50%
• All other assets	100%
• Financing or liquidity facilities provided to the reporting Bank	0%
• Operational funds held at other financial institutions (including deposits held at centralised institution of network of co-operative banks)	0 %
<b>Other inflows by counterparty</b>	



• Amounts receivable from retail counterparties	50%
• Amounts receivable from non-financial wholesale counterparties, from transactions other than those listed in the above inflow categories	50%
• Amounts receivable from financial institutions and central banks, from transactions other than those listed in the above inflow categories	100%
• Net derivative receivables	100%
• Other contractual cash inflows	100%

83. The inflow rates provided in table 10B do not represent an assumption about the risk of a default—instead, it represents the likelihood that the relevant obligation will be rolled over (so that the Islamic Bank does not actually receive the cash) or that no cash will be received for some other reason. Inflows for which an inflow rate of 0% is specified are effectively treated as not being receivable.
84. An Islamic Bank calculating its cash inflows may include a contractual inflow from an exposure only if it is classified as performing or as “special mention” under BBR Rules, and there is no reason to expect a default within the relevant period. The Islamic Bank must not include any contingent inflows or any inflow that would be received from an asset in the its HQLA portfolio.
85. In a stressed situation, the assets in the Islamic Bank’s HQLA portfolio would already have been monetised. That is the purpose of those assets—to be monetised to provide liquidity. Consequently, in a scenario of liquidity stress, the contracted cash inflows from them would no longer be available to it. The Islamic Bank may include, in cash inflows during a period, profit margin that it expects to receive during the period.
86. If the collateral backing a secured credit, including margin financing transactions, has been rehypothecated, then the applicable inflow rate would be 0%, for all categories of secured credit and not the rate mentioned in Table 10B.
87. The inflow rate for credit facilities and liquidity facilities provided to an Islamic Bank is 0%.
88. The inflow rate for operational deposits held by an Islamic Bank with other financial institutions or banks is 0%. Operational deposits for this purpose would have the same meaning as used in calculation of net cash outflows.
89. The inflow rate for net derivative cash inflows is 100%. The Islamic Bank must calculate those inflows in accordance with its usual valuation methods. The inflows may be calculated on a net basis by counterparty (that is, inflows offset outflows) only if a valid master netting agreement exists. From the calculation, the Islamic Bank must exclude liquidity needs that would result from increased collateral needs because of market value movements or falls in the value of collateral lodged.
90. The Islamic Bank must assume that an option will be exercised if it is in the money to the buyer. If derivative cash inflows are collateralised by HQLA, the inflows are to be calculated net of any corresponding cash or collateral outflows that would result from contractual obligations for the Islamic Bank to lodge cash or collateral. However, this condition applies only if, after the collateral were received, the Islamic Bank would be legally entitled and operationally able to re- hypothecate it.



**Maturing secured financing, including reverse repos and securities borrowing**

91. An Islamic Bank should assume that maturing *Shari'ah*-compliant reverse repos or securities borrowing agreements secured by Level 1 HQLA will be rolled over and will not give rise to any cash inflows (zero %). Maturing reverse repos or securities borrowing agreements secured by Level 2 HQLA should be modelled as cash inflows, equivalent to the relevant haircut for the specific assets. An Islamic Bank is assumed not to roll-over maturing reserve repurchase or securities borrowing agreements secured by non-HQLA assets and can assume it will receive 100% of the cash related to those agreements. Collateralised financings extended to customers for the purpose of taking leveraged trading positions, i.e. margin financings, should be modelled with a 50% cash inflow from contractual inflows made against non-HQLA collateral.
92. An exception to paragraph 50 above is the situation where, if the collateral obtained through *Shari'ah*-compliant reverse repos, securities borrowing or collateral swaps, which matures within the 30-day period, is re-used (i.e. rehypothecated) and is tied up for 30 days or longer to cover short positions. An Islamic Bank should then assume that such reverse repo or securities borrowing arrangements will be rolled over and will not give rise to any cash inflows (zero %), reflecting its need to continue to cover the short position or to repurchase the relevant securities.
93. An Islamic Bank should manage its collateral so that it is able to fulfil obligations to return collateral whenever the counterparty decides not to roll-over any reverse repo or securities financing transaction. This is especially the case for non-HQLA collateral, since such outflows are not captured in the LCR framework.
94. Lines of credit, liquidity facilities and other contingent funding facilities that an Islamic Bank holds at other institutions for its own purposes should be assumed to be able to be drawn and so such facilities should receive a 0 % inflow rate.
95. All inflows should be taken only at the latest possible date, based on the contractual rights available to counterparties. Inflows from financings that have no specific maturity should not be included, with the exception of minimum payments of principal, fee or interest associated with an open maturity financing.
96. Other contractual cash inflows should be included under this category. Cash inflows related to non-financial revenues should not be taken into account in the calculation of the net cash outflows for the purposes of the LCR. These items should receive an inflow rate of 100%.
97. The Islamic Bank must assume that inflows will be received at the latest possible date, based on the contractual rights available to counterparties. The following inflows are not to be included:
  - (a) inflows (except for minimum payments of principal, fee or profit) from financings that have no specific maturity;
  - (b) inflows related to non-financial revenues.

**Other requirements for LCR**

98. An Islamic Bank active in multiple currencies should:
  - (a) maintain HQLA consistent with the distribution of its liquidity needs by currency;
  - (b) assess its aggregate foreign currency liquidity needs and determine an acceptable level of currency mismatches; and
  - (c) undertake a separate analysis of its strategy for each currency in which it has material activities, considering potential constraints in times of stress.
99. In respect of the obligation to notify the AFSA about a real or potential breach of its LCR



requirement, an Islamic Bank in its notification should clearly explain:

- (a) the reasons for not meeting the limits;
- (b) measures that have been taken and will be taken to ensure it meets its LCR Requirement; and
- (c) its expectations regarding the potential duration of the situation.

100. The Islamic Bank should discuss with the AFSA what, if any, further steps it should take to deal with the situation, prior to making that notification.

### **Liquid assets buffer**

101. An Islamic Bank must, except during periods when it experiences liquidity stress, maintain a buffer of HQLA over the minimum level of LCR required according to Rule 10.27. The size of the HQLA buffer must be appropriate to the nature, scale and complexity of its operations and must also be determined considering the Islamic Bank's Liquidity Risk tolerance and the results of its liquidity stress tests. An Islamic Bank should conduct such liquidity stress tests to assess the level of liquidity it should hold beyond the minimum required under this section, and construct its own scenarios that could cause difficulties for its specific business activities. Such internal stress tests should incorporate longer periods than the ones required under Rule 10.12. Islamic Banks are expected to share the results of these additional stress tests with the AFSA. The AFSA may require an Islamic Bank to maintain an additional buffer of liquid assets in cases where the AFSA assesses that it has failed to carry out stress tests effectively.

### **B. Net Stable Funding Ratio (NSFR)**

102. The requirement for a Bank to maintain a net stable funding ratio is one of the Basel Committee's key reforms to promote a more resilient banking sector. The requirement will oblige Banks including Islamic Banks, to maintain a stable funding profile in relation to the composition of their assets and off-balance-sheet activities. A stable funding profile is intended to reduce the likelihood that disruptions to a Bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure, and might lead to broader systemic stress. The requirement is intended to limit Banks' reliance on short-term wholesale funding, promote funding stability, and encourage better assessment of funding risk on and off Banks' balance-sheets.

103. In respect of this Section B of Appendix 1, the following are the key definitions:

- (a) ASF is defined as the amount of its available stable funding, calculated in accordance with this Section B.
- (b) carrying value of a capital instrument, liability or asset is the value given for the instrument, liability or asset in the prudential returns of the Islamic Bank concerned.
- (c) Net Stable Funding Ratio is defined in Rule 10.28.
- (d) NSFR means net stable funding ratio.
- (e) RSF is defined as the amount of its required stable funding, calculated in accordance with this Section B of Appendix 1.

### **Application to a Financial Group**

104. For calculating a consolidated NSFR for a Financial Group, assets held to meet an Islamic Bank's NSFR may be included in the parent entity's stable funding only so far as the related liabilities are reflected in the parent entity's NSFR. Any surplus of assets held at the Islamic Bank may be treated as forming part of the parent entity's stable funding only if those assets would be freely available to the parent entity during a period of stress.





105. When calculating its NSFR on a consolidated basis, a cross-border banking group must apply the Rules of its home jurisdiction to all the legal entities being consolidated, except for the treatment of retail and small business deposits. Such deposits for a consolidated entity must be treated according to the Rules in the jurisdiction in which the entity operates. A cross-border banking group must not take excess stable funding into account in calculating its consolidated NSFR if there is reasonable doubt about whether the funding would be available during a period of stress.
106. Asset transfer restrictions (for example, ring-fencing measures, non-convertibility of local currency, foreign exchange controls) in jurisdictions in which a banking group operates would affect the availability of liquidity by restricting the transfer of assets and funding within the group. The consolidated NSFR should reflect the restrictions consistently with this Rule. For example, assets held to meet a local NSFR requirement by a Subsidiary that is being consolidated can be included in the consolidated NSFR to the extent that the assets are used to cover the funding requirements of that subsidiary, even if the assets are subject to restrictions on transfer. If the assets held in excess of the total funding requirements are not transferable, the Islamic Bank should not count that funding.

### **Determining maturity of liabilities**

107. When an Islamic Bank is determining the maturity of an equity or liability instrument, it must assume that a call option will be exercised at the earliest possible date. In particular, if the market expects a liability to be exercised before its legal final maturity date, the Islamic Bank must assign the liability to the category that is consistent with the market expectation.
108. For long-dated liabilities, the Islamic Bank may treat only the part of cash flows falling at or beyond the 6-month and 1-year time horizons as having an effective residual maturity of 6 months or more and 1 year or more, respectively.
109. An Islamic Bank must calculate the value of a derivative liability based on the replacement cost for the derivative contract (obtained by marking to market) if the contract has a negative value. If there is a netting agreement with the counterparty that meets both of the conditions for the netting agreement and the other conditions referred in this and the following paragraph, the replacement cost for the set of exposures covered by the agreement is taken to be the net replacement cost. The conditions for the netting agreement are as follows:
- (a) the Islamic Bank should have a claim to receive, or an obligation to pay, only the net amount of the mark-to-market values of the transactions if the counterparty were to fail to perform; and
  - (b) the agreement does not contain a walkaway clause.
110. The other conditions are as follows:
- (a) the Islamic Bank holds a written, reasoned legal opinion that the relevant courts and administrative authorities would find the Islamic Bank's exposure to be the net amount referred to in paragraph (8) (a) above, under each of the following laws:
    - (i) the law of the jurisdiction in which the counterparty is established;
    - (ii) if a foreign branch of the counterparty is involved, the law of the jurisdiction in which the branch is located;
    - (iii) the law that governs the individual transactions;
    - (iv) the law that governs the netting agreement (and any other agreement necessary to effect the netting);
  - (b) the Islamic Bank has procedures to ensure that netting arrangements are kept under review





- in the light of possible changes in the relevant law;
- (c) the AFSA is satisfied that the netting agreement is enforceable under all of the laws referred to in paragraph (a).
111. Collateral lodged in the form of variation margin in connection with derivative contracts, regardless of the asset type, must be deducted from the negative replacement cost amount.
112. When determining the maturity of an asset, an Islamic Bank must assume that any option to extend that maturity will be exercised. In particular, if the market expects the maturity of an asset to be extended, the Islamic Bank must assign the asset to the category that is consistent with the market expectation. For an amortising financing like diminishing *musharakah* financing, the Islamic Bank may treat the part that comes due within 1 year as having residual maturity of less than 1 year.

#### **Inclusion of assets in RSF calculation**

113. When determining its RSF, an Islamic Bank:
- (a) must include financial instruments, foreign currencies and commodities for which a purchase order has been executed; but
- (b) must not include financial instruments, foreign currencies and commodities for which a sales order has been executed;
- even if the transactions have not been reflected in the Islamic Bank's balance- sheet under a settlement-date accounting model. This condition applies only if:
- (a) the relevant transactions are not reflected as derivatives or secured financing transactions in the Islamic Bank's balance-sheet; and
- (b) the effects of the transactions will be reflected in the Islamic Bank's balance-sheet when settled.

#### **Treatment of securities financing transactions**

114. When determining its RSF, an Islamic Bank must not include securities that the Islamic Bank has borrowed in *Shari'ah*-compliant securities financing transactions if the Islamic Bank does not have beneficial ownership. However, the Islamic Bank must include securities that it has lent in securities financing transactions if it retains beneficial ownership of them.
115. In addition, the Islamic Bank must not include securities that it has received through collateral swaps if those securities do not appear on the Islamic Bank's balance- sheet. The Islamic Bank must include securities that it has encumbered in repos or other securities financing transactions, if the Islamic Bank has retained beneficial ownership of the securities and they remain on the Islamic Bank's balance-sheet.

#### **Netting of securities financing transactions with a single counterparty**

116. When determining its RSF, a Islamic Bank may net securities financing transactions with a single counterparty only if all of the following conditions are met:
- (a) the transactions have the same explicit final settlement date;
- (b) the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of default, insolvency or bankruptcy; and
- (c) one of the following applies:
- (i) the counterparties intend to settle net;



- (ii) the counterparties intend to settle simultaneously;
- (iii) the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement.

117. Functional equivalent of net settlement means that the cash flows of the transactions are equivalent to a single net amount on the settlement date. To achieve that equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and that the linkages to collateral flows do not result in the unwinding of net cash settlement.

### Calculating *Shari'ah*-compliant derivative assets

118. When determining its RSF, an Islamic Bank must calculate the value of a *Shari'ah*-compliant derivative asset first based on the replacement cost for the contract (obtained by marking to market) if the contract has a positive value. If there is a netting agreement with the counterparty that satisfies all the conditions in paragraphs 116 and 117 above, the replacement cost for the set of exposures covered by the agreement is taken to be the net replacement cost.

119. Collateral received in connection with a *Shari'ah*-compliant derivative contract does not offset the positive replacement cost amount, regardless of whether or not netting is permitted under the Islamic Bank's accounting or risk-based framework, unless the collateral is received in the form of cash variation margin, and all of the following conditions are met:

- (a) either:
  - (i) the trades are cleared through a qualifying central counterparty; or
  - (ii) the cash received by the counterparty is not segregated;
- (b) the variation margin is calculated and exchanged every day, based on mark-to-market valuation of the relevant positions;
- (c) the variation margin is received in the same currency as the currency of settlement of the contract;
- (d) the variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the contract subject to the threshold and minimum transfer amounts applicable to the counterparty;
- (e) derivative transactions and variation margins are covered by a single master netting agreement (MNA) between the counterparties;
- (f) the MNA explicitly stipulates that the counterparties agree to settle net any payment obligations covered by the agreement, taking into account any variation margin received or provided if a credit event occurs involving either counterparty;
- (g) the MNA is legally enforceable and effective in all the relevant jurisdictions, including in the event of default, bankruptcy or insolvency.

120. Any remaining balance-sheet liability associated with initial margin received or variation margin received that does not meet all of the conditions in the (a) to (g) of the previous paragraph, does not offset derivative assets and receives a 0% ASF factor.

121. For the purposes of this section, a qualifying central counterparty is an entity that is licensed to operate as a central counterparty in relation to the instruments concerned and the financial regulator that is responsible for its prudential supervision:

- (a) has established Rules and regulations for central counterparties that are consistent with Principles for Financial Market Infrastructures, published by the International Organization



of Securities Commissions in July 2011; and

- (b) has publicly indicated that it applies those Rules and regulations to the entity on an ongoing basis.

### Calculating ASF

122. The amount of an Islamic Bank's ASF is calculated using the following steps:

- (c) assign each of the Islamic Bank's capital items and liabilities to 1 of the 5 categories set out in the following paragraphs 123 to 127;
- (d) next, for each category add up the carrying values of all the capital items and liabilities assigned to the category;
- (e) next, for each category multiply the total carrying values of the capital items and liabilities assigned to the category by the category's ASF factor (also set out in paragraphs 123 to 127), giving the weighted amounts; and
- (f) add up the weighted amounts.

123. The Category 1 liabilities and capital that receive a 100% ASF factor include:

- (a) the total amount of the Islamic Bank's RC (as set out BBR Chapter 4), excluding any Tier 2 instrument with residual maturity of less than 1 year, before the application of capital deductions;
- (b) any other capital instrument that has an effective residual maturity of 1 year or more (except any instrument with an explicit or embedded option that, if exercised, would reduce the expected maturity to less than 1 year);
- (c) the total amount of secured and unsecured borrowings and liabilities (including term deposits) with effective residual maturities of 1 year or more.

For (c) above, cash flows falling within the 1-year horizon but arising from liabilities with final maturity of more than 1 year do not qualify for the 100% ASF factor.

124. The Category 2 liabilities that receive 95% ASF factor include stable deposits (as defined in Section B of this Appendix 1 of IBB Module), with residual maturities of less than 1 year provided by retail and small-business customers.

125. The Category 3 liabilities that receive 90% ASF factor are the liabilities that receive a 90% ASF factor are less stable deposits (as defined in Section B of this Appendix 1 of IBB Module) with residual maturities of less than 1 year provided by retail and small-business customers.

126. The Category 4 liabilities that receive 50% ASF factor include the following:

- (a) funding (secured and unsecured) with residual maturity of less than 1 year, from corporate customers that are not financial institutions;
- (b) operational deposits (as defined in Section B of this Appendix 1 of IBB Module);
- (c) funding with residual maturity of less than 1 year from sovereigns, public sector entities, MDBs and national development banks;
- (d) other funding (secured or unsecured) not falling within the previous paragraphs (a) to (c), with residual maturity of between 6 months and 1 year, including funding from central banks and financial institutions.

127. The Category 5 liabilities that receive 0% ASF factor include the following:

- (a) capital not included in Category 1 for this calculation;



- (b) liabilities not included in Category 1 to 4 for this calculation;
- (c) other liabilities without a stated maturity, except that:
  - (i) a deferred tax liability must be categorised according to the nearest possible date on which it could be realised; and
  - (ii) minority interest must be treated according to the term of the instrument, usually in perpetuity.

Funding from central banks and financial institutions with residual maturity of less than 6 months would fall within paragraph (b) above.

- (d) NSFR derivative liabilities net of NSFR derivative assets, if NSFR derivative liabilities are greater than NSFR derivative assets;

**Note** For how to calculate NSFR derivative liabilities, please refer paragraphs 107 to 111 of this section of Appendix 1 of the IBB Module. For how to calculate NSFR derivative assets, please refer paragraphs 118 to 121 of this section of Appendix 1 of the IBB Module.

- (e) trade-date payables arising from purchases of financial instruments, foreign currencies and commodities that:
  - (i) are expected to settle within the standard settlement cycle or period that is customary for the relevant exchange or type of transaction; or
  - (ii) have failed to settle, but are still expected to do so.

128. Other liabilities without a stated maturity could include short positions, positions with open maturity and deferred tax liabilities. A liability referred to in paragraph 127 (c) above would receive either a 100% ASF factor if its effective maturity were 1 year or more, or a 50% ASF factor if its effective maturity were between 6 months and 1 year.

### Calculating RSF

129. An Islamic Bank's RSF is calculated following these steps, in the same sequence as they are listed below:

- (a) assign each of the Islamic Bank's assets to 1 of the 8 categories set out in paragraphs 130 to 137 of this Section of Appendix 1 of the IBB Module;
- (b) then, for each category add up the carrying values of all the assets assigned to the category;
- (c) following that, for each category multiply the total carrying values of the assets assigned to the category by the category's RSF factor (also set out in paragraphs 130 to 137), giving the weighted amounts;
- (d) next, multiply the amounts of each of the Islamic Bank's off-balance-sheet exposures by the exposure's RSF factor (set out in paragraph 139), giving the OBS weighted amounts;
- (e) finally, add the weighted amounts and the OBS weighted amounts.

130. The Category 1 assets that receive 0% RSF factor include the following, subject to the paragraphs 138 & 139, which pertain to certain encumbered assets:

- (a) currency notes and coins immediately available to meet obligations;
- (b) central bank reserves (including required reserves and excess reserves);
- (c) claims on central banks with residual maturities of less than 6 months;
- (d) trade-date receivables arising from sales of financial instruments, foreign currencies and



commodities that:

- (i) are expected to settle within the standard settlement cycle or period that is customary for the relevant exchange or type of transaction; or
- (ii) have failed to settle, but are still expected to do so.

131. The Category 2 assets that receive 5% RSF factor include the assets that receive a 5% RSF factor are unencumbered level 1 HQLA (except assets that receive a 0% RSF factor under paragraph 140).
132. The Category 3 assets that receive 10% RSF factor include unencumbered financings to financial institutions, with residual maturities of less than 6 months, that are secured against level 1 HQLA that the Islamic Bank can freely re- hypothecate during the financings' life.
133. The Category 4 assets that receive 15% RSF factor include unencumbered level 2A HQLA and unencumbered financings to financial institutions, with residual maturities of less than 6 months, that do not fall within Category 3 assets as defined in paragraph 180.
134. The Category 5 assets that receive 50% RSF factor include the following:
- (a) unencumbered level 2B HQLA;
  - (b) HQLA that are encumbered for between 6 months and 1 year;
  - (c) financings, with residual maturity of between 6 months and 1 year, to financial institutions and central banks;
  - (d) operational deposits (as defined in paragraphs 40 to 52 of this Section B of Appendix 1 of IBB Module) at other financial institutions;
  - (e) all other non-HQLA with residual maturity of less than 1 year, including financings to non-financial corporate clients, financings to retail customers and small business customers, and financings to sovereigns and public sector entities.
135. The Category 6 assets that receive 65% RSF factor include unencumbered residential financings, with residual maturity of 1 year or more, that qualify for a risk weight of 35% or lower (according to Rules in Chapter 6 of IBB Module) and other unencumbered financings (except financings to financial institutions), with residual maturity of 1 year or more, that qualify for a risk weight of 35% or lower (according to Rules in Chapter 6 of IBB Module).
136. The Category 7 assets that receive 85% RSF factor include the following types of assets, subject to the paragraphs 138 & 139, which pertain to certain encumbered assets:
- (a) cash, securities or other assets lodged as initial margin for derivative contracts, and cash or other assets provided to contribute to the default fund of a central counterparty;
  - (b) unencumbered performing assets (except credits to financial institutions), with residual maturity of 1 year or more, that do not qualify for a risk weight of 35% or lower, under Rules in Chapter 6 of IBB Module;
  - (c) unencumbered securities with residual maturity of 1 year or more;
  - (d) exchange-traded equities that are not in default and do not qualify as HQLA;
  - (e) physical traded commodities, including gold.
- Despite (a) above, if securities or other assets lodged as initial margin for derivative contracts would otherwise receive a higher RSF factor than 85%, they retain that higher factor.

137. The Category 8 assets that receive 100% RSF factor include the following:



- (a) assets that are encumbered for 1 year or more;
- (b) NSFR derivative assets, net of NSFR derivative liabilities, if NSFR derivative assets are greater than NSFR derivative liabilities;
- (c) all other assets not falling within categories 1 to 7 (including non- performing assets, financings to financial institutions with residual maturity of 1 year or more, non-exchange-traded equities, fixed assets, items deducted from RC, retained interest, insurance assets, Subsidiary interests and defaulted securities);
- (d) 20% of derivative liabilities as calculated in accordance with this section B of Appendix 1 of IBB Module.

**Treatment of encumbered assets**

138. Assets encumbered for between 6 months and 1 year that would, if unencumbered, receive an RSF factor of 50% or lower receive a 50% RSF factor. Assets encumbered for between 6 months and 1 year that would, if unencumbered, receive an RSF factor higher than 50% receive that higher RSF factor. Assets encumbered for less than 6 months receive the same RSF factor as an unencumbered asset of the same kind.

139. The AFSA may direct a Islamic Bank that, for the purposes of calculating the Islamic Bank's NSFR, assets that are encumbered for exceptional central bank liquidity operations receive a specified lower RSF factor than would otherwise apply. In general, exceptional central bank liquidity operations are considered to be non- standard, temporary operations conducted by a central bank to achieve its mandate at a time of market-wide financial stress or exceptional macroeconomic challenges. The RSF factors for off-balance-sheet exposures are as follows:

- (a) irrevocable and conditionally revocable credit and liquidity facilities—5% of the undrawn portion;
- (b) contingent funding obligations—as set out in table 10C.

**Table 10 C: Contingent funding obligations—RSF factors**

Item	Kind of obligation	RSF factor (%)
1	Irrevocable or conditionally revocable liquidity facilities	5
2	Irrevocable or conditionally revocable credit facilities	5
3	Unconditionally revocable liquidity facilities	0
4	Unconditionally revocable credit facilities	0
5	Trade-finance-related obligations (including guarantees and letters of credit)	3
6	Guarantees and letters of credit unrelated to trade finance obligations	5
7	Other non-contractual obligations, including:	
	(a) potential requests related to structured investment vehicles and other similar financing arrangements	0





	(b) structured products where customers anticipate ready marketability (such as adjustable-rate notes and variable-rate demand notes)	0
	(c) managed funds that are marketed with the objective of maintaining a stable value	0

### C. Maturity Mismatch Approach

#### Including inflows (assets) and outflows (liabilities) in the time bands

140. Outflows (liabilities) must be included in the Maturity Ladder according to their earliest contractual maturity. Contingent liabilities may be excluded from the Maturity Ladder only if there is a likelihood that the conditions necessary to trigger them will not be fulfilled.
141. Inflows (assets) must be included in the Maturity Ladder according to their latest contractual maturity, except that:
- (a) undrawn committed standby facilities provided by other banks are included at sight;
  - (b) marketable assets are included at sight, at a discount, and
  - (c) assets which have been pledged as Collateral are excluded from the Maturity Ladder.

#### Including marketable assets in the Maturity Ladder

142. Assets which are readily marketable are included in the Maturity Ladder in the sight - 8 days time band, generally at a discount to their recorded value calculated in accordance with the table below. An asset is regarded as readily marketable if:
- (d) prices are regularly quoted for the asset;
  - (e) the asset is regularly traded;
  - (f) the asset may readily be sold, either on an exchange, or in a deep and liquid market for payment in cash; and
  - (g) settlement is according to a prescribed timetable rather than a negotiated timetable.
143. The AFSA may allow, on a case by case basis, an Islamic Bank to include a longer term asset which is relatively easy to liquidate in the sight - 8 days time band. The discount factor to be applied to types of marketable assets must be determined by reference to the following table:

Item	Benchmark discount
<b>Central government debt, Local Authority paper and eligible bank bills (Credit Quality Grade of 1, 2 or 3)</b>	
Central government and central government- guaranteed marketable Securities with twelve or fewer months' residual maturity, including treasury bills; and eligible local authority paper and eligible bank bills.	0%





Other central government, central government- guaranteed and local authority marketable debt with five or fewer years' residual maturity or at variable rates.	5%
Other central government, central government- guaranteed and local authority marketable debt with over five years' residual maturity.	10%
<b>Other Securities denominated in freely tradable currencies (Credit Quality Grade of 1, 2 or 3)</b>	
Non-government <i>sukuk</i> which are Investment Grade, and which have six or fewer months' residual maturity.	5%
Non-government <i>sukuk</i> which are Investment Grade, and which have five or fewer years' residual maturity.	10%
Non-government <i>sukuk</i> which are Investment Grade, and which have more than five years' residual maturity.	15%
Equities which qualify for a specific Risk weight no higher than 4%.	20%
<b>Other central government debt</b>	
Where such debt is actively traded.	20%
Exposures to a central government or a Central Bank where such Exposures are actively traded	20%
Where the issuer is a central government or a Central Bank and the issue is actively traded but the credit Exposure is not to the Issuer	40%
Non-government, actively-traded Exposures, which are Investment Grade	60%

144. The AFSA may vary the discounts to reflect the conditions of a particular market or institution.



## APPENDIX 2: GROUP RISK

### A. Introduction

1. This appendix to the IBB Module sets out the rules, guidance and norms required to fulfil the regulatory requirements in respect of managing the Group Risk associated with Islamic Banks which are a constituent of Financial Groups. These rules, guidance and norms supplement the regulatory requirements set out in the Rules in Chapter 11 of IBB Module. These elements convey the supervisory expectations of the AFSA regarding Group Risk and its management by an Islamic Bank. The AFSA will use these rules, norms and key elements specified here to assess compliance with IBB Module on Group Risk.
2. Chapter 11 of IBB Module includes rules for an Islamic Bank:
  - (a) to implement an effective management framework for Group Risk exposure; and
  - (b) to ensure capital adequacy at the level of the Financial Group.
3. Chapter 11 of IBB Module also includes requirements limiting Financial Group exposures and restrictions on the ownership or control of Banks.
4. Group Risk refers to the risk of potential losses incurred by an Authorised Firm on account of its relationship with other members of its Financial Group, if it were to be part of one. Group membership may be a source of both strength and weakness to an Authorised Firm. The purpose of Group Risk requirements is to ensure that an Authorised Firm takes proper account of the risks related to the Authorised Firm's membership of a Group. The Group Risk requirements form a key part of the AFSA's overall approach to prudential supervision.

### B. Financial Group - Requirements

5. For the purposes of BBR Rule 11.1, the AFSA would consider a range of factors when requiring an Authorised Firm to form a Financial Group. These factors would include regulatory risk factors, including but not limited to, (direct and indirect) participation, influence or contractual obligations, interconnectedness, intra group exposures, intra group services, regulatory status and legal framework.
6. If more than one member of the same Group is subject to an obligation to provide information in respect of a position of the Group or Financial Group, one or more of those Authorised Firms may make application to the DFSA for an appropriate waiver or modification.
7. For the purposes of Rule 11.4 (1), an Islamic Bank may take into account its position within its Group. For instance, it would be reasonable for a small Islamic Bank within a larger Group to place some reliance on its parent to ensure that appropriate systems and controls are in place.

### C. Financial Group Capital Requirements

8. If an Islamic Bank breaches Rules 11.4 (1) and 11.4 (2), the AFSA will take into account the full circumstances of the case, including any remedial steps taken by another regulator or the Islamic Bank, in determining what enforcement action, if any, it will take.
9. Capital resources or adjusted capital resources would not be freely transferable if they are subject to an obligation to maintain minimum Capital Requirements to meet domestic solvency requirements, or to comply with debt covenants. In general, capital resources or adjusted capital resources are considered not to be freely transferable if they are subject to a legal or constructive limitation on their transferability, whether that transfer would be made by dividend, return of capital or other form of distribution. Examples of relevant limitations might include obligations to maintain minimum capital Requirements to meet domestic solvency requirements, or to comply with debt covenants.



10. The following examples are provided to illustrate the application of Rule 11.6.
- (a) The concentration risk limit which requires that the total of an Islamic bank's net exposures to a counterparty or connected counterparties must not exceed 25% of its Regulatory Capital (RC) applies to its Financial Group, so that the Financial Group's net exposures to a counterparty or connected counterparties must not exceed 25% of the Financial Group's RC, calculated using the Rules in Chapter 11 of IBB Module.
  - (b) Similarly, the limit in IBB Module in Chapter 5, which require that the total of all of the Islamic Bank's net large exposures must not exceed 800% of its RC) applies to its Financial Group, so that the Financial Group's total net large exposures to counterparties or connected counterparties must not exceed 800% of the Financial Group's RC, calculated using the Rules in chapter 11 of IBB Module.
11. Because the Financial Group Capital Requirement set out in Rule 11.5 includes Capital Requirements in respect of Group entities, capital resources may be included in the calculation of Financial Group capital resources to the extent of those requirements. Capital that is surplus to those requirements is, however, subject to an additional condition before it may be taken into account for the purposes of Financial Group capital adequacy.



### **APPENDIX 3: SUPERVISORY REVIEW AND EVALUATION PROCESS**

#### **A. Introduction**

1. This appendix to the IBB Module sets out the rules, guidance and norms required to fulfil the regulatory requirements in respect of the regulatory requirements relating to supervisory review and evaluation process outlined in Chapter 14 of the IBB Module. These rules, guidance and norms supplement the regulatory requirements set out in the Rules in Chapter 14 of IBB Module. These elements convey the supervisory expectations of the AFSA regarding completion of the ICAAP process by an Islamic Bank. The AFSA will use these rules, norms and key elements specified here to assess compliance with IBB Module on ICAAP process.

#### **B. Financial Group - Application**

2. In relation to Rule 14.1, if an Islamic Bank is part of a Financial Group which is already subject to requirements prescribed in Chapter 14, the AFSA may consider a request for a waiver or modification in relation to those requirements.

#### **C. Internal Capital Adequacy Assessment Process (ICAAP)**

3. An Islamic Bank is required to carry out an ICAAP as detailed in Chapter 14 of the IBB Module and in this appendix. This process enables an Islamic Bank to determine and maintain an adequate amount and quality of capital, relative to its risk profile. More information and guidance on the establishment of an ICAAP and the manner of carrying out an ICAAP assessment is elaborated in this section.
4. The ICAAP is an internal process of an Islamic Bank which enables it to determine and maintain the amount and quality of capital that is adequate in relation to the Islamic Bank's risk profile as assessed by conducting a comprehensive internal risk assessment process. Islamic Banks are encouraged to maintain capital over and above the regulatory minimum capital. The ICAAP, which should be based on an internal risk assessment process, should be embedded in the Islamic Bank's business and organisational processes.
5. When assessing its capital needs, an Islamic Bank should take into account the impact of economic cycles, and sensitivity to other external risks and factors. For larger or more complex institutions, this may mean developing an appropriate stress testing and scenario testing framework. The AFSA does not prescribe any specific approach for the ICAAP and, consequently, an Islamic Bank can choose to implement an ICAAP which is proportionate to the nature, size and complexity of the business activities. In completing an ICAAP, an Islamic Bank must:
  - (a) estimate the amount of capital required to absorb potential losses, if any, for the significant risks identified through an internal risk assessment process;
  - (b) perform reasonable and proportionate sensitivity tests to analyse the impact of variation in the risk parameters of significant risks identified in the internal risk assessment process on the profitability and the capital position of the Islamic Bank;
  - (c) estimate, using the range and distribution of possible losses estimated from historical data, the level of capital required reasonably to cover likely losses;
  - (d) estimate the capital required to address potential increase in the Islamic Bank's Capital Requirement to support planned growth in business levels or any significant deviation in growth from plans; and
  - (e) document the ranges of capital required for each of the factors identified above and enable the Governing Body and the senior management to form an overall view on the amount and quality of capital which that Islamic Bank should hold.
6. The AFSA does not require an Islamic Bank to implement ICAAP through sophisticated models and the AFSA has no prescribed approach for developing an internal capital model for the Islamic Bank's ICAAP assessment. However, an Islamic Bank should be able to demonstrate:



- (a) the methodologies and metrics employed in assessment of various non-financial risks like *Shari'ah* non-compliance risk;
  - (b) the confidence levels set and whether these are linked to its corporate strategy;
  - (c) the time horizons set for the different types of business that it undertakes;
  - (d) the extent of historic data used and back-testing carried out;
  - (e) that it has in place a process to verify the correctness of the model's outputs; and
  - (f) that it has the skills and resources to operate, maintain and develop the model.
7. If an Islamic Bank's internal model makes explicit or implicit assumptions in relation to correlations within or between risk types, or in relation to diversification benefits between business lines, the Islamic Bank should be able to explain to the AFSA, with the support of empirical evidence, the basis of those assumptions. An Islamic Bank's model should also reflect the past experience of both the Islamic Bank and the sectors in which it operates.
8. The assumptions required to aggregate risks that are modelled and the confidence levels adopted should be considered by the Islamic Bank's senior management. An Islamic Bank must also consider whether any relevant risks, including but not limited to *Shari'ah* non-compliance risk, systems and control risks, are not captured by the model.
9. An Islamic Bank using an internal capital model must validate the assumptions of the model through a comprehensive stress testing programme. In particular, this validation should:
- (a) test correlation assumptions (where risks are aggregated in this way) using combined stresses and scenario analyses;
  - (b) use stress tests to identify the extent to which the Islamic Bank's risk models omit non-linear effects, for instance the behaviour of derivatives in Market Risk models; and
  - (c) consider not just the effect of parallel shifts in market interest rate curves, but also the effect of those curves becoming steeper or flatter.
10. Any internal assessment of capital adequacy should address diversification benefits and transferability of capital resources between members of the Islamic Bank's Financial Group. It should also describe the distribution of the capital required by its Financial Group across all entities, including the Islamic Bank.

**D. Supervisory Review and Evaluation Process (SREP)**

11. The guidance provided in this section of Appendix 3, covers the evaluation criteria and methodology for the supervisory review and evaluation process (referred to as SREP) that the AFSA may use when reviewing and evaluating the ICAAP of an Islamic Bank.
12. The documented results of the ICAAP assessment is required to be submitted to the AFSA. The AFSA will then employ the SREP process to evaluate the quality, completeness and consistency of the ICAAP of the Islamic Bank, to form a view on the overall risk profile of the Islamic Bank and to assess whether the capital held by the Islamic Bank is sufficient to deal with the risks faced by it.
13. Following a review of the ICAAP of an Islamic Bank, the AFSA may engage in a dialogue with the Islamic Bank to evaluate its self-assessment of its risk exposures and where relevant, determine the amount of additional capital which the AFSA considers that the Islamic Bank should hold resulting from the ICAAP or SREP.
14. The AFSA may conduct a SREP to review and evaluate the assessments carried out by an Islamic Bank under its ICAAP. The AFSA may engage with an Islamic Bank in a dialogue where, following an SREP, the AFSA considers that it is or may be appropriate to impose an Individual Capital Requirement on the Islamic Bank. It is important that an Islamic Bank cooperates in an open and co-operative manner with the AFSA in the course of its conduct of the dialogue.



**E. The SREP in detail**

15. A SREP of an ICAAP forms an integral part of the overall supervisory approach of the AFSA. A SREP is expected to enable assessment of the effectiveness, completeness and quality of an ICAAP in relation to the overall risk profile of the Islamic Bank. It leverages from information collected and assessments carried out as part of the wider supervisory regime, including desk-based reviews, on-site risk assessments, discussions with the Islamic Bank's management, and reviews completed by internal and external auditors.
16. The SREP is structured to provide consistency of treatment across Islamic Banks, taking into consideration the differences in risk profiles, business strategies and management. An essential element of the SREP is the qualitative assessment of each type of risk and its management within the overall context of the Islamic Bank's internal governance.
17. The AFSA's assessment of the individual risk profile of an Islamic Bank will provide the context for evaluation of the Islamic Bank's ICAAP. The evaluation in turn will be used by the AFSA to augment its understanding of the overall risk profile of that Islamic Bank. Also, in relation to an Islamic Bank, the AFSA might involve the Islamic Bank in a formal discussion of risks and capital adequacy, which might lead to a requirement for additional capital.
18. The SREP for each Islamic Bank will be proportionate in terms of the size, scale and complexity of its business and its impact on financial sector stability. The AFSA will cooperate actively with other supervisory authorities whenever an Islamic Bank is part of a Financial Group and is prudentially regulated on a consolidated basis.
19. The SREP evaluation cycle will be determined in the discretion of the AFSA and be based on the risk assessment, developments in the risk profile and changes in the Islamic Bank's strategy or products. The SREP is as far as possible aligned with the risk assessment process to ensure that a recent risk assessment is available for the SREP evaluation process.
20. It is envisaged that the AFSA will use a range of supervisory tools of qualitative or quantitative nature to perform the SREP. The SREP is not intended as, and should not constitute, a parallel or secondary ICAAP. Its purpose is to evaluate the quality, completeness and consistency of the ICAAP of the Islamic Bank.

**F. Review of the ICAAP Assessment**

21. Upon receipt of an ICAAP the AFSA would normally:
  - (a) subject the data employed in ICAAP and its results, to an initial analysis for completeness and accuracy followed by a more detailed comparison with the relevant data held on file at the AFSA about the Islamic Bank;
  - (b) determine if there are material changes compared with previous submissions;
  - (c) determine if the submitted data contains indicators of a possible material change in the Islamic Bank's risk profile;
  - (d) address and discuss any information gaps or anomalies with the Islamic Bank; and
  - (e) form an assessment about content and quality of the submission which will be integrated into the overall supervisory approach.

**G. Evaluation of the ICAAP**

22. The SREP evaluation of the ICAAP covers all activities of an Islamic Bank and takes all relevant data collected during the supervisory process into account. The SREP evaluation process will use desk based reviews, visits and meetings to arrive at a final view. As part of the SREP, the AFSA will consider:
  - (a) the completeness of the ICAAP by ensuring that it covers all business areas, internal governance and all risk categories of the Islamic Bank;
  - (b) the soundness and quality of the ICAAP process in relation to the Islamic Bank's size,





- business complexity and risk profile;
  - (c) soundness of qualitative calibration and quantitative methodology whenever employed by the Islamic Bank;
  - (d) execution of the ICAAP in terms of consistency, quality and documentation;
  - (e) adequacy of internal controls and quality assurance processes on the ICAAP; and
  - (f) adequacy of management information and whether the management had responded adequately and in a timely manner to such information.
23. Based on the SREP, the AFSA will form an assessment which will be communicated to the Islamic Bank and flow into the overall supervisory approach. The action required resulting from the ICAAP will be communicated to the Islamic Bank as part of a risk mitigation programme.
24. In relation to an Islamic Bank, where the AFSA does not agree with the results of the Islamic Bank's ICAAP results, the AFSA will involve the Islamic Bank in a dialogue to reconcile any difference in view to arrive at a consensus estimate of the capital level required to address all risks identified either by the Islamic Bank or by the AFSA in its SREP. Such an estimate will be specified by the AFSA as the Individual Capital Requirement for the Islamic Bank. Where consensus is not possible the AFSA may impose an Individual Capital Requirement on that Islamic Bank.

#### **H. Individual Capital Requirement (ICR)**

25. Upon completing the SREP, the AFSA may impose an Individual Capital Requirement on an Islamic Bank as detailed in Chapter 14 of IBB. The ICR may be imposed where the AFSA concludes that the Islamic Bank should hold more capital to provide for its overall risks.





## APPENDIX 4: PUBLIC DISCLOSURES REQUIREMENTS

### A. Introduction

1. This appendix to the IBB Module sets out the rules, guidance and norms required to fulfil the regulatory requirements in respect of the regulatory requirements relating to public disclosure requirements set out in Chapter 15 of the IBB Module. These rules, guidance and norms supplement the regulatory requirements set out in the Rules in Chapter 15 of IBB Module. These elements convey the supervisory expectations of the AFSA regarding fulfilment of the public disclosure requirements for an Islamic Bank. The AFSA will use these rules, and key elements specified here to assess compliance with Chapter 15 of IBB Module.
2. The purpose of the requirements in this chapter is to ensure that minimum public disclosures are made available to market participants to assist them in forming an opinion on the risk profile and capital adequacy of an Islamic Bank.

### B. Disclosure Policy

3. An Islamic Bank has discretion to determine the form of the disclosures required, and may choose to use graphical and other representations where appropriate.
4. The formal disclosure policy setting out internal controls and procedures for disclosure of information required to fulfill the rules in Chapter 15 of IBB, must be approved by the Governing Body of the Islamic Bank. The key elements of the disclosure policy must be disclosed along with the annual regulatory disclosures.
5. Information provided by an Islamic Bank to comply with the rules in Chapter 15 of IBB Module must be, at a minimum, subject to the same level rigour and diligence applied in the internal audit, review and internal control processes for the external financial reporting by the Islamic Bank (i.e. the level of assurance must be the same as for information provided within the management discussion and analysis part of the audited annual report).
6. An Islamic Bank is expected to provide narrative commentaries including but not limited to, commentaries to explain any significant changes occurring in quantitative disclosures between successive reporting periods.
7. An Islamic Bank must make the disclosures required to comply with the rules in Chapter 14 of IBB Module must be published in a stand-alone document that is readily accessible for market participants and any investor. An Islamic Bank may append the disclosures document with its annual audited report & financial statements. In such cases, the disclosures must be appended to the annual report as a distinct section or module which is easily identifiable to potential readers and investors.
8. An Islamic Bank making these disclosures must maintain records of the disclosures made by it and make those archives available, at least for a retention period specified by the AFSA in its GEN rules.
9. An Islamic Bank must disclose information that is material in the sense that its omission or misstatement could influence an investor or a market participant relying on that information for the purpose of making legitimate economic or risk assessments, and/or decisions regarding compliance with Shari'ah requirements. A qualitative judgment (use test) based on the needs of the investor or that of the market participant should be used as the appropriate benchmark of materiality. The Islamic Bank should determine the level of materiality threshold used in deciding its disclosures and the same must be disclosed as part of the formal disclosure policy referred in paragraph 2 above.

### C. Signposting



10. An Islamic Bank may make the required disclosures in a dedicated document separate from the documents in which they are mandated by Rule 15.3 (3) to make the disclosures the tables required by this Chapter, provided the criteria specified in paragraph 11 are met. In such cases, the Islamic Bank must signpost clearly in the mandated periodic statements, as to where the separate disclosure requirements can be accessed. This signposting must include:
  - (a) the title and number of the disclosure requirement;
  - (b) the full name of the separate document in which the disclosure requirement has been published;
  - (c) a web link, where relevant; and
  - (d) the page and paragraph number of the separate document where the disclosure requirements can be located.
11. The information disclosures required and prescribed tables may be disclosed by an Islamic Bank in a separate dedicated document other than that required by the rules in Chapter 15 of IBB Module, provided the document is clearly signposted and all of the following criteria are met:
  - (a) the information contained in the signposted document should be equivalent in terms of presentation and content to that required in the template and capable of enabling users to make meaningful comparisons with information disclosed;
  - (b) the information contained in the signposted document is based on the same scope of consolidation as the one used in the disclosure requirement; and
  - (c) the disclosure in the signposted document is mandatory.
12. An Islamic Bank can only make use of signposting to another document if the level of assurance on the reliability of data in the separate document are equivalent to, or greater than, the internal assurance level required for regulatory disclosure document required by the rules in Chapter 15 of IBB Module.

### **D. Detailed disclosure requirements**

13. An Islamic Bank must, in order to fulfil its disclosure requirement specified in Chapter 15 of the IBB Module, complete all the tables and templates specified in IFSB Standard 22 on disclosures to promote transparency and market discipline for Islamic Banks, except the tables and templates in Section 9 of the standard on consumer protection.