Consultation on Proposed Amendments to the Credit Risk Management Module (CM) for Locally Incorporated Banks – Major Acquisitions

Industry Comments and Feedback
Islamic Banks
January 2016

Specific Comments:			
Reference to the draft Directive:	**Comments**	**REF**	**CBB's Response**
Definitions and Aggregate Limit on Large Exposures **CM-4.4.1A '<u>Capital instrument</u>' includes all components of equity capital including ordinary equity, both voting and non-voting, and preference shares. It also includes convertible or hybrid financial instruments which are debt – like in character and which may be converted into equity (such as convertible murabaha). Also for financial institutions and insurance companies, any other financial instruments (such as subordinated debt) which are eligible as regulatory capital should also be included as <u>capital instruments</u>. Sukuk or senior debt instruments would not normally be regarded as "<u>capital instruments</u>" unless they have convertibility features. Equity-like contracts such as joint venture musharaka contracts (<u>investments</u> but not financing) are also included in this definition. The musharaka stake is classified as a <u>capital instrument</u> at onset.**	**<u>A bank</u>** asks is there any point retaining CM-4.4.1A/B/C? The same definitions of "capital instrument", "acquisition" and "investment" are in the Glossary.	SP-1	It is useful to have it both in the Module and in the glossary.

CM-4.4.1B ‘Acquisition’ means the acquiring by a bank of beneficial or legal ownership of capital instruments issued by another entity. This would not include securities underwriting until the expiry of the underwriting period (where separate arrangements apply elsewhere in this Module). Acquisition may also be in the form of exercising of rights to take control of capital instruments pledged as collateral. The pledging of capital instruments by a customer to a bank as collateral (e.g. for the purpose of obtaining credit) does not in itself mean that an “acquisition” has taken place. Acquisition also does not include the establishment of new subsidiaries by the bank. Regulatory requirements for the establishment of SPVs and subsidiaries are contained in Section BR-5-2.	**A bank** suggests replacing the highlighted “another entity” by “third party that is not a subsidiary of the bank”. Shouldn’t this change be made given the highlighted wording in the definition of “investment”? Further, **the bank** suggests to Delete the below highlighted sentence if above change made.	SP-2	We see no harm in specifically mentioning that subsidiaries are not included.
CM-4.4.1C ‘Investment’ is any holding by a bank of capital instruments issued by a third party that is not a subsidiary of the bank. Therefore holdings of subordinated debt eligible as regulatory capital issued by another financial institution would be regarded as an “investment”. In this case ‘holding’ means legal or beneficial ownership of capital instruments.	**A bank** asks if there is any real difference between ‘acquisition’ and ‘investment’? Both relate to the bank getting hold of capital instruments issued by a third party.	SP-3	Acquisition refers to acquiring equity of another entity, while investment is a broader concept.

CM-4.4.1E **A “~~significant investment~~” “major acquisition or investment” ~~in a commercial entity~~** is defined as any acquisition or investment in the capital instruments of another ~~commercial~~ entity by a Bahraini Islamic bank licensee which is equivalent to or more than 10% of the ~~issued common share capital of the issuing commercial entity~~ Bahraini Islamic bank licensee’s consolidated total capital.	**A bank** would request adding the definition of the “consolidated total capital” in the CM module and making a reference to the total capital amount as reported in the quarterly PIRI.	SP-4	We do not see the need.
	A bank inquires about the rationale for using “acquisition” and “investment” even though both mean the same.	SP-5	Refer to SP-3
	A bank asks: Should the definition of “major acquisition or investment” be moved to the Glossary?	SP-6	Refer to SP-1

	A bank agree with the changes made to paragraph CM 4.4.1E as now the risk is more aligned to the size of the bank not the size of the entity. We would however like to draw your attention to paragraph BR 5.2.9 of Rulebook Vol. 2 where the banks have to seek approvals prior to obtaining 20% or more of the equity capital of an SPV. This too should be amended in the same manner as CM 4.1.1E. As SPV's could be created with very small capital and to obtain the CBB's prior approval for acquiring 20% of that equity capital would result in obtaining approvals for very minimal amounts.	SP-7	Will be studied.
CM-4.4.1F [This Paragraph was deleted in January 2015.]	**A bank** suggests if definitions are to be included in both the Glossary and Module CM, maybe the definition of "significant investment" should also be included here.	SP-8	The concept of "significant investment" was removed from Module CM and the glossary. "Major investments" are now introduced to the Module and to the Glossary.
CM-4.4.2 Total Capital has the same meaning as when used in Section CA-1.1.	**A bank** noted that the word "consolidated" needs to be added at the start of sentence to ensure consistency with CA-1.1.	SP-9	Refer to SP-4.

CM-4.9.3 All <u>Bahraini Islamic bank licensees</u> must obtain the CBB's ~~approval~~ prior written approval before to ~~t~~making a ~~"significant investment"~~ "major acquisition or investment" (as described in CM-5.5.1E) in another ~~commercial~~ entity (whether incorporated inside or outside of Bahrain).	**<u>A bank</u>** inquires if this requirement would be applicable for all new investments going forward.	SP-10	<u>Yes.</u>
CM-4.9.3B Where the percentage ownership increase is due to revaluation or change in the capital of the bank, the bank must provide a written notification to the CBB, outlining the percentage increase and the reason for such increase.	**<u>A bank</u>** noted that this needs to include change in ownership due to change in capital structure of investee company as well.	SP-11	Disagree- the change in capital structure of investee company is not relevant to this rule.
CM-4.9.3E Banks must notify the CBB of any <u>acquisition</u> or <u>investment</u> that constitutes 5% or more of the <u>Bahraini Islamic bank licensee's</u> consolidated total capital.	**<u>A bank</u>** asks for a clarification: 1. If this is applicable to new investments? 2. If the bank invests an amount exceeding 10% of consolidated total capital, will CM 4.9.3 as well as CM4.9.3E both apply? 3. If bank notifies CBB for an investment in excess of 5% of its capital and subsequently the exposure is increased by more than 5%, will the licensee continue to notify CBB?	SP-12	Paragraph CM-4.9.3E was deleted from the final rules issued.
	<u>A bank</u> would like to object to this new paragraph as it is an additional reporting requirement that does not commensurate with the risk of the bank. There are already checks and balances in place in terms of the investment amounts and exposures such as the large	SP-13	Refer to SP-12 - Paragraph CM-4.9.3E was deleted from the final rules issued.

	exposure limits (including the connected counterparties, related parties and aggregate exposure limits), major acquisitions limits for approval, SPV creation acquisition approvals. There are also sufficient reporting to include the monthly connected counterparty exposure and the quarterly large exposure reports to name a few. Where full information is provided please also see paragraph CM 4.9.10 and BR 5.2.11		

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CBB Criteria for Assessment of Investments and Acquisitions Bahraini Islamic Bank Licensees CM-4.9.10 In assessing any proposed investments or acquisitions mentioned above, the CBB will take into account the following points: (a) The amount of the proposed investment or acquisitions relative to the existing consolidated Total Capital of the bank. (b) Existing capital adequacy ratios on consolidated basis and forecast ratios after the investment or acquisition has gone ahead. (c) The adequacy of information flows from the investee company to the concerned bank. (d) Experience and fit and proper matters relating to the senior personnel associated with the proposed investment or acquisition. (e) Risks associated with the proposed acquisition or investment. (f) Disclosure and exchange of (supervisory) information (in the case of a foreign investment or acquisition). (g) Adequacy of host supervision (in the case of a foreign investment or acquisition). (h) Current investments and concentrations in exposures of the concerned bank.	**A bank** asks for a clarification regarding point (P) how the funding needs to be highlighted? As typical funding is always part of its liquidity management strategy, and may not resort to new capital unless the investment size is huge.	SP-14	The bank needs to explain in their application how they plan to fund the transaction.

(i) The compliance of the concerned bank with the CBB's rules and regulations (e.g. reporting issues), and the adequacy of internal systems and controls. (j) The extent of holdings by any other shareholders (holding 5% or more of the capital of the concerned entity) or controllers of the concerned entity. (k) Whether the proposed activities are in line with the Memorandum & Articles of Association of the bank. (l) The accounting treatment of the proposed investment. (m) Whether the investment or acquisition relates to a closely-linked party, connected party, or controller in any way. (n) The existence of secrecy laws or constraints over supervisory access to the premises, assets, books and records of the concerned entity in which a "significant investment" is being acquired. (o) The impact and extent of goodwill and intangibles upon the capital adequacy and balance sheet of the bank on a consolidated basis. (p) The bank's existing and forecast liquidity position (as a result of the acquisition) and how the acquisition is to be funded (e.g. by the issuance of new capital or sale of other investments).			

	A bank suggests the following changes: (l) The accounting treatment of the proposed investment or acquisition; (m) Whether the investment or acquisition relates to a closely-linked party, connected party, or controller in any way; (n) The existence of secrecy laws or constraints over supervisory access to the premises, assets, books and records of the concerned entity ~~in~~ which is the subject of a ~~significant~~ major acquisition or investment ~~is being required~~; (o) The impact and extent of goodwill and intangibles upon the capital adequacy and balance sheet of the bank on a consolidated basis; and (p) The bank's existing and forecast liquidity position (as a result of the investment or acquisition) and how the investment or acquisition is to be funded (e.g. by the issuance of new capital or sale of other investments).	SP-15	The reference will be to "Major Investments" throughout the Paragraph.
	A bank noted that Paragraph 4.9.10(n) still use the term "significant investment"	SP-16	Agree – Refer to SP-15.
CM-4.10.1 No Bahraini Islamic bank licensee may have a significant investment in the capital instruments of a commercial entity where the significant investment amount and any other exposure to the subject entity is more than 15% of the concerned bank's consolidated Total Capital.	**A bank** noted that this includes reference to significant investments- Please clarify if these definitions are different from major investments. Also reference to commercial entities are removed in CM 4.9 while this is retained here.	SP-17	CM-4.9 (which have been changed to Major Investments), is for the purpose of prior approval, and is defined in CM-4.4.1E. CM-4.10 (Significant investments in Commercial Entities-have not been changed), is for the purpose of sitting limits (i.e. the 15% Single Limit, and the 60% Aggregate Limit) as dealt with in Module CA, if exceeded to be risk weighted at 800%. Therefore, **Please note that CM-4.9 and CM-4.10 have different definitions and different purposes**.

	A bank noted that Paragraph 4.10.1 still use the term "significant investment"	SP-18	Refer to SP-17
CM-4.10.3 ~~**The CBB may allow the limits in Paragraphs CM-4.9.6 and CM-4.9.7 above to be exceeded, provided that the concerned bank has addressed the points outlined in Paragraph CM-4.9.10 to the satisfaction of the CBB.**~~ **Any excesses above the limits in Paragraphs CM-4.10.1 and CM-4.10.2 must be risk-weighted according to Paragraph CA-2.4.25.**	**A bank** noted that the new Paragraph CM-4.10.3. proposes to delete the wording " The CBB may allow limits in Paragraphs CM 4.10.1 and 4.10.2.2 to be exceeded, provided that the concerned bank has addressed the points outlined in Paragraph CM 4.9.10 to the satisfaction of CBB." The bank thinks that deleting the above wordings will severely restrict the Investment banks in doing investment business. Therefore this Clause should be retained in the Paragraph CM.4.10.3. Investment banks may sometimes need to invest more than 15% of the capital in instruments of commercial entities.	SP-19	Any proposed transaction that would lead to an excess exposure must be priorly approved by the CBB. Deleting the first part of the paragraph doesn't restrict banks from exceeding the mentioned limits.