Industry Comments & the CBB Feedback Statement on the Consultation on the proposed Approval requirements for Major Acquisitions by Locally Incorporated Banks (CP-5) – Module CM Rulebook-Volumes 1 & 2 – Conventional/Islamic bank licensees
January 2011

Industry Comments	CBB's response
General Comments:	
A bank agrees with the regulations proposed and noted that the requirements appear to be reasonable. However, **it** noted that the bank may exceed the large exposure limits (15% single & 60% aggregate) just due to appreciation in the market value of such investments and not necessarily due to additional acquisition. Therefore, it is suggested to exempt the need to obtain CBB's approval for such excesses.	For any increase in the bank's ownership of any of its existing qualifying holdings, the Bank must revert back to the CBB for prior approval. Banks must only notify the CBB for any increase in the value of such ownership where it is due to reasons such as revaluation, change in the capital of the bank, reduction in the size of the investee's capital, etc. where the deduction rule would apply immediately on such increment.
A bank supports the CBB to reduce the level of systemic risk through alignment with Basel CP-5. However, it requested that that the Large Acquisition Rules be revised to state clearly that exposures that banks intend to be temporary in nature, such as underwriting exposures and exposures to securities that a bank intends to place with investors, do not constitute Qualifying Holdings and, if the exposure exceeds 15% of a bank's consolidated capital base upon expiration of the temporary exposure period, the exposure will only be subject to normal large exposure limits and capital deductions in accordance with current Module CM.	It should be noted that August consultation paper on the amendments to large exposure limits does not give any blanket exemption for either underwriting exposures or the temporary investment exposures. The rules state that any underwriting exposure/syndicated loan commitment to an unconnected counterparty or temporary investment with the intention for resale above the 15% single exposure limit must be subject to the CBB's prior approval; However, the maximum level of such exposures per counterparty that the CBB may approve, must not exceed 30% & 25% of the concerned bank's consolidated capital base for a maximum 90-day period with regards to the underwriting exposures & temp investment exposures respectively . The normal deduction rules would apply in both cases after the 90- day period. The measures in this paper do not apply to underwriting of securities, where separate measures are applied in Module CM. These measures do apply upon the expiry of the 90 days temporary periods approved by the CBB which allows banks to reach a maximum underwriting limit of 30% of regulatory capital . With regards to holdings of securities, it must be subject to CP-5 whether the intention is to resell or hold such securities . The risk of such "temporary"

	investments will be the same for the acquiring bank as a direct purchase on own account, especially in cases where the bank find difficulties in reselling such investments.
A bank recommended that the CBB needs to consider some form of carve out for "wholesale" banks from the application of these proposed approval thresholds and Directive. The core business of these types of institutions is to invest equity in potential transactions to realize a capital gain over the medium term. The proposed approval thresholds in the Bank's opinion are more suited for retail banking institutions and the Bank supports the CBB in its efforts to ensure compliance with Basel regulations.	Disagree- This is a Basel requirement for all banks. If wholesale banks consider that their business model is in fact investment based, then they should be licensed as investment firms where the regulatory frame work is more geared to their business model. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance .
Submission Process: **one of the banks** noted that there is no real clarity as to the specific process of submission or any indicative feedback timeframe from the CBB. Surely some sort of long stop date should be put in place to give applicants some certainty in the commercial negotiations. Forced Exit: What happens where the CBB potentially forces a disposal to occur (possibly also at a loss)? What is the legal remedy side of things? The Bank knows that this is a delicate issue but possibly an important one in the current market. Appeal: The proposed directive should include a provision for an appeal process if disagreement on whether an investment should be approved or not if it is felt that the decision arbitrary.	The paper will be amended to incorporate a timeframe of two weeks for CBB's response from the date of receiving a complete set of all the required documents . As banks are aware, the CBB closely involves itself with banks in discussions on Large Exposures and so an Appeals Process is not deemed necessary as investments are simply a form of exposure and the current system has been in place for a number of years.

A bank noted that it fully supports the introduction of an effective framework with respect to major investments being done by locally incorporated banks. Thus the Bank believes that normal exposures which a bank may have by way of a loan are not covered under the proposed guidelines and will continue to be guided by the large exposure limits covered under Module CM of the Rule book.	Agree- any other type of exposure which does not fall within the definition of qualifying holdings will be subject to the normal large exposure limits in the CM Module. Moreover, it should be clear that any qualifying holding will also be subject to the normal large exposure limits.
A bank requested a grace period to be compliant with the proposed paper as against immediate compliance. This will enable the Banks to analyze their current position and chalk out a strategy to be compliant with the proposed limits.	The new approval requirements of paragraphs 4.4 to 4.6 will apply promptly for all new investments and acquisitions, but not retroactively to current exposures or investments. All existing qualifying holdings would be grandfathered with respect to the limits outlined in paragraphs 4.7 and 4.8, however, banks will not be allowed to further invest in any new qualifying holdings until they reduce their excessive exposure below these limits.
A bank stated that it would help if the paper could specify that the capital base as per PIR to be used for calculating the thresholds should be the Available Capital pre-deductions.	Agreed – the Regulatory capital is to be used as a base for calculating the thresholds. The capital should be post all deductions except large exposure & CP-5 deductions for commercial entities.

A bank inquired: what would be the treatment for market value changes either in the capital base of the investment entity or that of the Capital Instrument?	These are general risk management issues.
The banks stated that for wholesale banks, the criteria suggested in the circular impose qualification hurdles similar to those for obtaining license. For wholesale banks, the criteria impose censorship on what would be shareholders' and directors' discretion with regard to commercial issues in nature.	The limits are set by Basel to prevent over-concentration and to limit equity-based activities, and so if a bank is to be allowed to exceed these limits then some criteria must be set. Ideally a bank should not be exceeding these limits as deduction occurs if they are exceeded.
If the bank is a wholly owned subsidiary of another financial institution then what would be the denominator capital (the concerned bank capital or the parent bank capital as ultimately the parent owns the risk of the subsidiary)?	The concerned bank capital should be used. Parent may provide guarantees subject to applicable limits.
Does the bank still require the CBB approval if the bank owns the investment because of realizations of collateral (because of counterparty default) against financing activities or owning the investments because of underwriting commitments.	In the event of a default, the CBB will not stop banks legal rights in enforcing collateral, however, the CBB must be notified if a bank exercises its rights over securities taken as collateral where the amount of the collateral is equal to or exceeds the thresholds specified in this paper. Such exercise of rights will constitute an acquisition and the concerned bank will have to give a plan for the disposal of the concerned assets taken as collateral to bring the investment back below the relevant limit(s).

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Specific comments:

Proposed Rule	comments	CBB's Response
2.2 This paper does not replace existing requirements. It should be read in conjunction with Module PCD of the CBB Rulebook (Volumes 1 & 2) which outlines the capital treatment of material holdings by banks of securities issued by other entities. This paper supplements and should be read with Module CM of Volumes One and Two of the Rulebook. The requirements in this paper do not replace the large exposure limits in Module CM (particularly the 15% exposure limit). The limits in this document apply specifically to holdings of capital instruments issued by another entity. This paper does not apply to any subsidiaries of the bank	**A bank** stated that the consultation paper propose to make it mandatory for all locally incorporated banks to seek the CBB's prior approval before investing in any entity which exceeds 10% of the investee bank's capital or is in excess of 20% of the capital of the entity which is being acquired. This is in comparison to the existing regulation which requires CBB approvals for exposures in excess of the 15% of the capital base of the Bank or at the time of establishment of SPV's and subsidiaries. The Bank believes that reductions in the allowed investment limits are too drastic and will be onerous for larger banks like them which operate as a network of entities - writing exposures to their associates / affiliates become inevitable due to their operating structure and business model. Highly stringent thresholds will also put Bahraini incorporated banks at a disadvantage with their peers in the region. In light of the above, the Bank strongly suggests that the current limits are not altered. Emphasis should be placed on adherence to the current limit structure rather than proposing more stringent limits. **A bank** noted that this paragraph states that the regulations would apply if a bank were to exercise its rights over securities taken as collateral. In the event of a default, it may be critical for the bank to enforce its collateral expeditiously (in order to protect its interests) and if the Bank were to require the consent of the CBB at a highly time-sensitive stage of the process, this may adversely affect the Bank's ability to enforce its legal rights. The CBB could consider allowing banks to first enforce the security in the interests of the Bank, following which the CBB's approval can be obtained.	Disagree. These limits are required by Basel (Core Principle-5), the intention as stated is to prevent concentration of activities in equity-investments by banks. This paper does not apply to any subsidiaries of the bank which are included through line-by-line consolidation in the consolidated PIR of the reporting bank. In the event of a default, the CBB will not stop banks legal rights in enforcing collateral, however, the CBB must be notified if a bank exercises its rights over securities taken as collateral where the amount of the

which are included through line-by-line consolidation in the consolidated PIR of the reporting bank. The measures in this paper are intended to apply where a bank acquires holdings of Capital Instruments of another entity with the objective of ownership and/or control of the concerned entity, or where the size of the investment is large relative to the eligible capital of the concerned bank. The measures in this paper do not apply to underwriting of securities, where separate measures are applied in Module CM. These measures do not apply if a bank takes securities as collateral for credit facilities. These measures do apply once temporary underwriting periods expire, or if a bank exercises its rights over securities taken as		collateral is equal to or exceeds the thresholds specified in this paper. Such exercise of rights will constitute an acquisition and the concerned bank will have to give a plan for the disposal of the concerned assets taken as collateral to bring the investment back below the relevant limit(s).

<table>
<tr><td>collateral.</td><td></td><td></td></tr>
<tr><td>2.3 There are three levels at which prior approval is required. The first is in respect of a holding in an entity amounting to 10% or more of the concerned bank's capital, the second is in respect of 20% or more of the capital of the concerned entity being acquired and the third in respect to any proposed increases on such exposures going forward.</td><td>

A bank noted that this new Directive introduces a new threshold of 20% of the investment entity, this means that any bank can only invest in companies with capital 50% or more than the Bank's own capital.

<table>
<tr><th>Bank's Capital</th><th>10% of Bank's Capital</th><th>Floor Capital of Investment company (applying 20%)</th></tr>
<tr><td>$100M</td><td>$10M</td><td>$50M</td></tr>
<tr><td>$150M</td><td>$15N</td><td>$75M</td></tr>
<tr><td>$200M</td><td>$20M</td><td>$100M</td></tr>
</table>

This could prove counterproductive to the mid and small companies seeking growth capital. It could be argued that the small and mid companies would represent the back bone for growth in the GCC in the medium term. Applying both thresholds combined might lead to limiting investment in only large cap companies. Alternatively, Banks would be investing smaller controlling interests in investment in small companies, thus increasing risk of control (or lack of).

A bank noted that applying both thresholds for wholesale banks defeats the principal of wholesale, as the Qualifying Holding would be a small stake in a large investment entity that would provide little or no control and involvement in the management of the investment entity, hence increasing the risk nature of the investment.

</td><td>

The Directive does not prevent banks from investing in smaller companies. It simply requires that the fact that a bank has made an investment in the capital of another entity to be reflected as a deduction from the investing bank's capital if it is above certain specified thresholds. These thresholds are put in place to address excessive risk concentration by banks. Banks' primary role is to act as intermediaries to seek investors in companies rather than to use regulatory capital for commercial purposes.

Disagree- This is a Basel requirement for all banks. If wholesale banks consider that their business model is in fact investment based, then they should be licensed as

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		investment firms where the regulatory frame work is more geared to their business model. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance.
	A bank noted that the requirement for three prior approval levels needs to be reconsidered. For the wholesale bank, it should be at least 15% of the investee bank capital base which is in line with the large exposure limit. There is also a need to rationalize the criteria of pre CBB approval, and banks should be allowed to get approval from CBB similar for taking approval for large exposure.	Disagree- the approval requirement for qualifying holdings must start at 10%. This limit is as per Basel requirements
	A bank noted that apparently, the same thresholds will apply to investments in financial institutions which is not appropriate in view of the riskiness of the sector and its repercussions to the whole economy.	The same limit will apply to investment in financial institutions in order to void the double-leveraging of capital and to see how much unencumbered capital is available in the market.

	Approval Limit and Assessment Criteria: **A bank** noted that the proposed regulation is imposing a "one size fits all" approval limit to acquisitions of capital instruments to all banks incorporated in Bahrain irrespective of their individual circumstances. The limits proposed by the CBB may be appropriate for one bank but might not be appropriate for another. Indeed, the consultation paper was issued pursuant to Basel Core Principle 5, which whilst it encourages central banks to set criteria for acquisitions of capital instruments including setting a limit in absolute terms and/or in relation to a bank's capital, the principle doesn't provide any guidance as to the quantum of the limit. Any limit should be determined by considering the risk appetite of the bank and the materiality of the risk of the acquisition in the context of the bank's balance sheet. Moreover, Core Principle 5 includes as "essential criteria" "laws or regulations provide criteria by which to judge individual proposals", whereas the consultation paper lists only information the CBB requires to assess an application without any guidance as to how the CBB will come to a determination. Core Principle 5 refers to "risks" and therefore the criteria must factor in a full risk assessment of the proposed acquisition.	Disagree- The scope of Basel 2 clearly mentions materiality thresholds for investments. If wholesale banks consider that their business model is in fact investment based rather than finance based, then they should be licensed as investment firms where the regulatory framework is more geared to their business model. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance. The list of information enables the CBB to take into account any salient factors in the assessment of proposed acquisitions which exceed the materiality thresholds.

3.1 For the purpose of this paper, the following definitions apply: Capital instrument – This 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. 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 capital instruments. Sukuk or senior debt instruments would not normally be regarded as "capital instruments" for the purpose of this paper unless they have	**A bank** noted that in the case of hybrid instruments, would the approval be required at initial investment of the hybrid instrument? How would the rule apply for calculating the potential conversion? **A bank** noted that for Islamic banks using Musharaka contacts (or diminishing Musharaka), how would those be treated? Would the Musharaka stake be classified as a Capital Instrument at onset or exit? Other Islamic financing structures that are based on sale contract that would be required to be treated as equity according to AAOIFI, how would those be treated? **A bank** noted that the criteria also applies to the investments in subordinate debt but what would be the treatment of short term debt which usually has a maturity of two years or less but according to Basel II eligible for tier 3 capital (which is used for the operational risk).	Yes the approval will be required at the initial investment in the convertible hybrid instrument .The potential conversion will be calculated at the strike/conversion price. These limits would apply only in the "Joint Venture Musharaka contracts"(investment & not financing) as they are equity like contracts. Financing Musharaka would only be subject to the normal large exposure limits and not to the limits introduced in this paper. The Musharaka stake will be classified as a Capital Instrument at onset. It would be subject to the same limits.

convertibility features.	**Definition of Capital Instruments** **A bank** noted that the definition of capital instrument includes convertible debt. Such instruments should be looked at on a case by case basis rather than being generalized. Frequently, convertibility features are included to enhance the deal risk/return profile from the outset. By capturing these as part of the exposure is restrictive in nature.	Disagree- any financial instruments (such as subordinated debt) which are eligible as regulatory capital with convertible feature should also be included as capital instruments.
Acquisition – Thus 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 Module CM). 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	**Definition of Acquisition** **A bank** noted that acquisition in the form of exercising of rights to take control of capital instruments pledged as collateral are included as part of the definition of "Acquisitions". This affects bank's ability to have free access to collateral as it determines fit to manage its credit exposure.	In the event of a default, the CBB will not stop banks legal rights in enforcing collateral, however, the CBB must be notified if a bank exercises its rights over securities taken as collateral where the amount of the collateral is equal to or exceeds the thresholds specified in this paper. Such exercise of rights will constitute an acquisition and the concerned bank will have to give a plan for the disposal of the concerned assets taken as collateral to bring the investment back below the relevant limit(s).

subsidiaries by the bank. Regulatory requirements for the establishment of SPVs and subsidiaries are contained in Module HC-1.5. Investment – An 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" for the purpose of this paper. "Exposure" has the same meaning as outlined in Module CM of the Rulebook.	**Acquisitions and Investments** **A bank** stated that investments of the following types should be excluded: 1. Investments in special purpose vehicle (SPV) with nominal (or very small) capital used in syndicated financing and securitization transactions. 2. Investments in Funds/ Collective Instruments where a bank invests 20-50% of the Fund but less than 10% of the bank's capital base. 3. Subordinated loans that either have recourse to a third party or secured otherwise (thereby eliminating the equity risk). 4. Debt instruments that may be converted into equity only at the option of the Investor.	1. Disagree. No scope under CP5 for such exclusion. 2. Disagree – see above. 3.If loans are subordinated to other creditors they obtain a characteristic of equity which would indicate that such loans should be included. 4- Disagree
	A bank stated that there doesn't seem to be any difference between the concepts of 'acquisition' and 'investment' (as defined). The investment is simply what the bank has after completing the acquisition. The definition of 'investment' specifically refers to subordinated debt whereas the definition of 'acquisition' does not, but presumably purchasing sub debt would be an acquisition.	The definition of capital instrument will be amended to clearly include subordinated debts.
	A bank stated that using the term "Capital Instrument is not per international norms when dealing with equity and given its similarity to the term Capital Markets instrument may well cause confusion. A term such as "Equity related	Disagree

	instrument" (or even "Equity instrument") may well be more suited and clear to the reader, especially since it is equity and quasi equity being addressed. ➢ **Exclusion of Mezzanine and/ or unsecured debt**: Within the definition itself the debt side of instruments is limited to sukuk and senior debt. Shouldn't buying mezz and/or unsecured debt also be excluded?	This would be normal large exposures unless it has a conversion feature.
	➢ Clarity on c: Would "Shari'a compliant investment notes" which are neither equity (as the holders do not acquire a right to attend or vote at general meetings of the company, receive dividends or share in any distribution of assets on a winding-up) nor debt (as there is no assured return and the investment notes get paid only if the concerned entity generates a profit) be considered as a capital instrument?	Such Shari'a compliant investment notes are unlikely to be capital instruments unless convertible – normal large exposure rules would apply.
	➢ Exclusion of subordinated debt: While subordinated debt is treated as a capital instrument for the purpose of calculating regulatory capital, the Bank feels that subordinated debt should not be considered for the purpose of the new measures on major acquisitions. Subordinated debt does not provide the holder with ownership of the entity nor control. In fact, a holder of subordinated debt has the right to claim the amount due from the issuing entity. The only difference between senior debt and subordinated debt is that the subordinated debt ranks below senior debt (but higher than equity) in the event of an insolvency. Hence, the Bank feels that subordinated debt should be excluded from the definition of capital instrument.	Disagree- any other financial instruments (such as subordinated debt) which are eligible as regulatory capital with convertible feature should also be included as capital instruments.
3.2 A bank is defined as "closely linked" with: a. Any person/entity which qualifies	**<u>Close Links</u>** **<u>A bank</u>** stated that in paragraph (c): Associate company should be defined (e.g. a company in which the bank has between 20% and 50% equity).	The term "Associate" is already defined in the Glossary, a reference can be

as a "controller" of the concerned bank as defined in Module GR-5 of the Rulebook; b. Any entity which is a subsidiary of the bank; c. Any entity which is an associate company of the bank.		added. *Associate* *A company or other enterprise, which is not a subsidiary or joint venture, over which the bank licensee has significant influence. Significant influence means the power to participate in financial and operating policy decisions. Such influence is presumed to exist if the bank licensee owns more than 20 percent of the associate.*
3.4 A "qualifying holding" for the purposes of this Paper is defined as: a. Any investment in or control (e.g. by revocable proxy) over the capital instruments of another entity by a locally incorporated bank which is equivalent to or	3.4(a) **A bank** believes that proxies do not represent commitment of capital from the proxy owner (unlike say a guarantee), and the Bank thinks that including proxies as part of qualifying holding consideration for exposure to capital does not seem appropriate.	Agree- Only legal & beneficial ownership would be considered for the purpose of defining the "qualifying holdings". The definition of qualifying holding would be amended to exclude proxies.

more than 10% of the locally incorporated bank's capital base (as reported in the most recent PIR submitted to the CBB;) or b. Any investment by or exercise of control by a locally incorporated bank of 20% or more of the capital instruments of the concerned entity.	3.4(b) **A Bank** stated that there could be situations where a locally incorporated bank acquires 20% or more of the capital instruments of an entity for an immaterial/insignificant amount. The bank requested the CBB to consider setting a threshold and exempt all investments below this threshold from the definition of "qualifying holding". **A Bank** stated that in the definition of qualifying holding, the materiality of the holding should only be determined based on the criteria set in 3.4 (a) i.e 10% or more of the capital base. The criteria given in 3.4 (b) i.e 20% or more of the capital instruments of the concerned entity can work for commercial bank but in case of investment banks doing venture capital and investing in entities with small capital base, the banks will have to take approval on insignificant investment also. For example, if the Bank invests 2 million in an entity with 10 million USD Capital then it will have to take an approval from CBB even though it will only form 1.5% of its capital base.	Directive does not prevent banks from investing in smaller companies. It simply requires that the fact that a bank has made an investment in the capital of another entity to be reflected as a deduction from the investing bank's capital if it is above certain specified thresholds. These thresholds are put in place to address excessive risk concentration by banks. Banks' primary role is to act as intermediaries to seek investors in companies rather than to use regulatory capital for commercial purposes. See comment above

	"Qualifying Holding" **A Bank** stated that Paragraph (b) may create an administrative burden for the CBB and the banks and unnecessarily delay transactions, especially if the investee's capital instruments are immaterial in relation to the bank's capital base. This paragraph is redundant unless a materiality threshold is introduced based on the bank's capital base.	See comment above
	A Bank noted that as "control" is a key term in the interpretation of "qualifying holding", the term "control" should ideally be defined.	Control is defined in Module PCD.
	A Bank stated that the CM module defines Capital Base as per PIR based on audited financials whereas here it is as per most recent PIR which can be interpreted as the interim quarter financials. Is this the intention?	If the most recent PIR is interim then yes
	A Bank stated that in a typical wholesale bank, the bank would initially underwrite the equity and then look to place up to 85% with investors over a period of 90 days. However, in order to ensure that the bank maintains control over the acquired entity, the shares are sold to investors but the bank retains voting control over those shares. The maintenance of voting control does not in any way mean that the bank's investment risk has increased. On the contrary, the Bank would argue that by not retaining such control, the risk would be significantly increased.	Fiduciary risk is retained, and the bank may be normally obliged to 'buy back' such shares.
	The Bank would therefore recommend that the definition of Qualifying Holding be amended to exclude control.	Agree- Only legal & beneficial ownership would

		be considered for the purpose of defining the "qualifying holdings". The definition of qualifying holding would be amended to exclude proxies.
	A Bank noted that proxies are normally taken from investors to ensure efficient management of the investment without having to revert to each and every investor for decision making. Therefore, to consider these proxies as part of the exposure would not be appropriate particularly given the requirements in Clause 4.7 and 4.8. This will restrict the bank's ability to do sizeable transactions unless capital is increased (which is not always possible and even if it was possible it would put additional burden on the Bank). This clause needs to be reviewed. It is the Bank's view that where investors have provided revocable proxies these should not be considered as control under the definition of qualifying holdings.	See comment above

4.2 Where a bank acquires a proportion of the capital instruments of another entity, the concerned bank acquires risk in that entity. The risk exposure to a bank through the acquisition of capital is arguably greater than that acquired by providing a loan or other conventional credit facilities in four ways: a. The rights of a shareholder are subordinated to those of ordinary creditors in the event of liquidation of the concerned entity. b. Loans and other shorter-term credit facilities have an explicit obligation on the borrower to repay the sum advanced or	*4.2 (b)* **A Bank** noted that its business model is to hold investment in equity for a period of typically three to five years and then sell the investment after having worked at growing it. In that sense, it can be claimed that there is no long term commitment to a private equity investment. Conversely, commercial banks may provide senior financing for longer periods (up to several decades). For these reasons, the Bank recommends that the CBB consider excluding Private Equity holdings from that definition. Though as a general rule, equity is considered riskier than debt, the Bank believes that strategic investment in equity may fit better the criteria as compared to private equity investment. *4.2 (c)* **A Bank** stated that its holding in private equity investments do not necessarily commit the Bank to fund long term activities of the investment; rather the aim is to achieve a capital gain through an exit in the medium term. The Bank may fund long term activity of the investee but there is no commitment. For that reason, the Bank recommends that the CBB consider excluding Private Equity holdings from that definition. **A Bank** agrees that the overall risks are greater in the case of equity investment but does not necessarily agree that the reputational and legal risk elements are any higher than in the case of providing only loans. However, in the case where the bank has a "control relationship" with the concerned entity then potentially there is higher risk of reputational and legal risks.	Disagree. There is a large body of evidence in Bahrain to show banks' inability to exit PE investments within the target timeframe. Disagree Disagree, PE holdings normally commit banks in practice to a period of years. Banks have previously faced difficulties in exiting within the target timeframe. The intention of CP-5 is to prevent excessive concentration in equity investments and to encourage banks to concentrate on their prime role as financial intermediaries providing

committed. Share capital has no such commitment (with the exception of some subordinated debt). Investments in the capital of an entity can only be realized by the sale of the concerned capital instruments to a third party, or by winding up the concerned entity. c. A capital investment in a third party entity (particularly where the investment is significant in size) is a pledge of capital to the concerned entity to fund its longer-term activities. The funds concerned are no longer available to be used by the investor bank to fund its activities. d. There may be reputational and legal risk to the investing		finance .

bank, particularly if the bank has a "control relationship" with the concerned entity.		
4.4 **All locally-incorporated banks must obtain the CBB's approval prior to taking a "qualifying holding" in another entity (whether incorporated inside or outside of Bahrain) and any future increases on such "qualifying holdings". Any bank wishing to acquire a "qualifying holding" in another entity must address the points outlined in Section 5 of this paper so that the CBB may make an informed review of the request. If the investment meets or**	A Bank noted that there is a need to rationalize the criteria of pre CBB approval, and banks should be allowed to get approval from CBB similar for taking approval for large exposure. **Deadlines** A Bank noted that Maximum period needs to be laid down for CBB to provide its approval in 4.4 **Initial Approval Requirement for "Qualifying Holdings"** A Bank stated that Pre-approval/review by the CBB would not be possible if an investment that was not a Qualifying Holding at inception, becomes a Qualifying Holding post-facto as a result of, inter alia: 1. Revaluations, allocation of stock dividends, or change in the capital base of the bank; or 2. Reduction in the size of the investee's capital instruments (as result of, say, repayment of subordinated loans, reduction of a tranche of equity, etc), (Not applicable if the Bank's suggestion for Qualified Holding is accepted).	The process for LE approval and for qualifying holding approval are essentially the same but with listed criteria for qualifying holdings. Agree, the paper will be amended to incorporate a timeframe of two weeks for CBB's response. For any increase in the bank's ownership of any of its existing qualifying holdings, the Bank must revert back to the CBB for prior approval. Banks must only notify the CBB for any increase in the value of such ownership where it is due to reasons such as revaluation, change in the capital of the bank, reduction in the size of the investee's capital, etc. where the deduction rule would apply immediately on

exceeds the "qualifying holding" thresholds as per the definition in section 3, then it may be treated as a "qualifying holding".	**A Bank** noted that it has observed that the CBB is becoming involved in micro-management of banks which may result in risk (both legal and reputational) for the CBB. It fully understands that for retail banks the CBB should have oversight and pre-approve transactions that are not in the ordinary course of their business and are likely to be of a strategic nature. In those instances you have correctly stated that the bank would have pledged its capital to the concerned entity to fund its longer-term activities and the funds are thus no longer available to be used by the investor bank to fund its core activities. However, in the case of wholesale banks the very nature of their business activities is to deploy their equity in order to realize a capital gain over the medium term. These investments are not of a strategic nature but form a core part of their daily business. As such the Bank would recommend that the CBB performs its supervisor role by focusing on the corporate governance framework and the risk management infrastructure of such institutions to satisfy itself that proper controls, procedures and approval processes are in place and are observed. The Bank believes that the CBB has already initiated this process through the Basel II Pillar 2 review of institutions. For those institutions that lack good corporate governance or do not follow them, the CBB should consider penalties either in terms of higher CAR requirements or more stringent liquidity requirements.	such increment. Disagree-This is one of the Basel core principles (CP-5). Disagree- This is a Basel requirement for all banks. If wholesale banks consider that their business model is in fact investment based, then they should be licensed as investment firms where the regulatory frame work is more geared to their business model. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance .

	A Bank therefore recommends that the CBB does not impose the condition of pre-approval for transactions that are in the ordinary course of business for a bank. Furthermore it would encourage the CBB to eliminate the need to obtain approval for establishing SPV's (under Module HC 1.5) for such transactions as they are part and parcel of doing such deals. However, the Bank continues to support the idea of approval of SPV's and Qualifying Holdings in case of strategic investments either in wholesale or retail banks. **A Bank** stated that all major strategic shareholders usually decide to contribute at-least their pro-rated share in a rights issue in order to maintain their pre-rights issue shareholding. Such contribution should be subject to the additional approval requirement only if the total contribution including such subscription to the rights issue exceeds 10% of the concerned bank's capital. Otherwise, such, contribution to capital increase based on a pro-rated rights issue should be excluded from the requirement of CBB's prior approval.	Disagree. SPVs are usually unregulated and part of CP-5's objectives is to seek to ensure that banks as a group (including SPVs) are adequately supervised. Fully consolidated SPVs won't be subject to the requirements in this paper. Any increase in the qualifying holdings (even by means of exercising rights issue) will require the CBB prior approval in case the total exposure after the rights issue exceeds 10% of the concerned bank's capital or 20% of the capital instrument of the entity being acquired.
4.6 **The CBB reserves the right to require locally-incorporated**	**A Bank** stated that the CBB proposes that approval will not be given for qualifying holdings in entities incorporated in jurisdictions where secrecy constraints exist, or there are restrictions on the passage of information to the	Any restrictions on the passage of information from the investee's company to the

banks to dispose of any qualifying holdings acquired without its prior approval. Where a "qualifying holding" is acquired without approval of the CBB, then the value of the holding must be deducted from the solo capital and from the consolidated capital of the concerned bank. Approval will not be given for "qualifying holdings" in entities incorporated in jurisdictions where secrecy constraints exist or there are restrictions on the passage of information to the bank (other than customer confidentiality requirements imposed by financial	bank. The term 'secrecy' is subjective, therefore, the Bank suggests that the CBB provides a clear definition of what the term 'secrecy' constitutes. A Bank noted that there is ambiguity with regard to investment in entities in jurisdictions where secrecy constraints exist. The circular forbids such investment without providing details on defining such jurisdictions. A Bank raised the following couple of points: (a) As proposed, the CBB would have the right to require locally incorporated banks to dispose of any qualifying holdings acquired without its prior approval. Does this mean the entire qualifying holding or only the excess above the relevant limit (10% or more of the bank's capital / 20% or more of the target's capital)? Disposing of the entire qualifying holding could be very disadvantageous to the acquiring bank, especially if the disposal has to be made promptly and during adverse market conditions. (b) The provision also says "*Approval will not be given for "qualifying holdings" in entities incorporated in jurisdictions where secrecy constraints exist or there are restrictions on the passage of information to the bank (other than customer confidentiality requirements imposed by financial regulators)*". A similar theme is picked up in paragraph 5(n). The concept of 'secrecy constraints' is not defined. On one interpretation it could effectively prevent taking a qualifying holding in a Cayman company (or a company incorporated in one of the other popular Caribbean locations), unless (per 2.2) post-acquisition the company is included through line-by-line consolidation in the consolidated PIR of the reporting bank. A Bank stated that it is not clear as to which countries would be considered as	concerned bank is consider secrecy constrain. See the above comment Where a "qualifying holding" is acquired without approval of the CBB, then the entire value of the holding must be deducted from the solo capital and from the consolidated capital of the concerned bank. Any restrictions on the passage of information from the investee's company to the concerned bank is consider secrecy constrain.

regulators).	those where secrecy constraints exist/there are restrictions on passage of information to the bank. It would be useful if the regulation could clarify that a country on the FATF high risk and non-cooperative jurisdictions would fall into this category.	See comment above
4.7 No locally-incorporated bank may have a qualifying holding in the share capital of an entity where the qualifying holding amount is more than 15% of the concerned bank's capital base.	**A Bank** believes that the capital adequacy module of the rulebook addresses effectively the concentration risk by means of capital deduction and that this additional rule is not necessary. **A Bank** noted that this would only apply if the earlier comments made above under clause 3.4(a) were considered acceptable, which is not the case here. Clearly this would restrict the size of investments that a Bank could do which in turn would impact the profitability and performance of the Bank, unless capital is increased which as indicated earlier is either not possible or would be a very expensive option. **A Bank** stated that given the proposed definition of Qualifying Holding (including control), for wholesale banks the capital deduction rules become rather distorted. The example below illustrates the point. Bank A with a capital of \$250m invests \$50 equity in a private equity transaction. It sells 85% of the equity (\$42.5m) to its investors (but retains revocable proxies in respect of the equity which is sold) and retains 15% (\$7.5m) on its balance sheet. According to the CBB's Large Exposure Policy any exposure above 15%	Disagree, CP-5 refers to capital investments and not to general concentrations of risk. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance. The restriction also impacts risk. Disagree. One of the benefits of CP-5 is to discourage leveraging. The intention of CP-5 is to limit overconcentration in investment activities.

	($37.5m) of the capital base of the bank will be deducted from capital. In the case above, applying the proposed definition of Qualifying Holding means that the bank has $50m exposure and therefore needs to deduct $42.5m from capital. This is a strange anomaly given that the bank only has $7.5m as balance sheet exposure. This is one further reason why the Bank suggests that the definition of Qualifying Holding should be amended to exclude Control. **A Bank** stated that for the purpose of calculating the large exposures limit (paras 4.7 and 4.8), if the Bank were to own 15% of the entity's shares and also have "control" of the entire entity (either through a proxy or a management contract), would: (a) only the Bank's holding of such entity's shares (i.e. 15%) be considered for the purpose of calculating the qualifying holding amount (as such term is used in 4.7); or (b) would the fact that the Bank controls all the entity's outstanding shares lead the CBB to conclude that the entire entity's shares should be used in the calculation of the qualifying holding amount, which would be 100%? As the CBB will note, electing option (a) or (b) would have very different results when calculating the qualifying holding amount.	The definition of qualifying holding would be amended to exclude proxies, only legal & beneficial ownership would be considered for the purpose of defining the "qualifying holdings". See comment above.
***4.8* The total amount of**	**A Bank** believes that the capital adequacy module of the rulebook addresses	Disagree, CP-5 refers to

a bank's qualifying holdings in other entities may not exceed 60% of the concerned bank's capital base.	effectively the concentration risk by means of capital deduction and that this additional rule is not necessary. **A Bank** noted that for Investment Banks particularly Islamic Investment Banks whose core activity is Equity Investment this limit is unduly restrictive and will no doubt have some serious implications on the Bank's ability to do business and to compete and grow and be profitable. For Islamic Investment Banks in particular the structure mainly circle around Equity Instruments and the proposed limit will restrict its activities and the balance capital would not be able to generate viable returns with a possibility that such balance capital would remain idle if this restriction is imposed. The Bank strongly suggests that this limit is increased and possibly linked to the Capital Adequacy Ratio (CAR). When seeking CBB approval, Banks could be required to present the overall CAR impact. CBB may consider imposing a requirement of a higher CAR where the limit of such investments exceeds a certain level; say 75% or more of the Banks Capital base. **A Bank** stated that this is a very restrictive limit for those banks whose principal business is investment in Private Equity and Real Estate. Restricting the total qualifying holding to a maximum of 60% would severely impact the bank's performance. Furthermore, many wholesale banks would look to leverage their balance sheets for use in investing in such transactions. By imposing a limit of 60% of the bank's capital base, there would not be any incentive for leveraging and would undermine the performance of such institutions both in terms of diversification of risks and performance. In addition, applying the proposed definition of Qualifying Holding magnifies	capital investments and not to general concentrations of risk. Disagree with the suggestion on increasing the CAR when investments exceed 75% of a Bank's Capital base. The limits introduced in this directive are as per Basel requirements and are internationally practiced.. If an institution's core activity is not the provision of credit, it should consider carefully what type of licence is the most suitable for it. An investment business licence may be more appropriate. Disagree. One of the benefits of CP-5 is to discourage leveraging.

	the negative impact on the total portfolio size of the bank. The example below illustrates the point. As before Bank A has $250m of capital and generally invests in deal sizes of $50m each and sells down to clients up to 85% of the exposure. In this way the bank could investment in 20 transactions (i.e. ($250*0.6)/$7.5m=20) with a total control over a $1bn of assets ($150m/0.15=$1bn) Using the proposed definition of Qualifying Holding, the bank would be forced to cap the total investments to $150m. In order to diversify its risk, the bank would need to invest either in smaller transactions or run a concentrated portfolio by investing in only 3 transactions (i.e. ($250*0.6)/$50m=3). The bank can try to reduce deal sizes in order to diversify risk, but then it becomes inefficient from a cost perspective. As the Bank has explained during the meeting the costs (due diligence, management time and placement team effort etc.) associated with undertaking a transaction are similar irrespective of the deal size and therefore it makes more economic sense to transact as large a transaction as possible, always keeping in mind the need for diversification. **A Bank** understands that in the spirit of the proposal, the CBB would consider investments in limited partnerships as being equivalent to investing in a capital instrument. **A Bank** noted that Section CA-3.2.27 of the rule book states that for the purpose of determining "large exposure limit" for investment in funds, the look-through approach should be used. The Bank's understanding of this rule is that the CBB would allow the use of the 'Look through' approach for investments in Private Equity and Real Estate funds. This is permitted as it is possible to uniquely identify the underlying investments and its risks. Given the illiquid nature of these investments, the fund composition is also unlikely to change on a frequent basis. However, in the case of mutual funds the look	This paragraph neatly summarises the intentions of CP-5 in this context.CP-5 is about risk management. A 'look through' approach should only be considered in funds which are liquid, transparent and traded on a daily basis..

	through approach may not be suitable due to frequent recalibration of the portfolio. Therefore, for mutual funds the CBB would look for the use of the Net Asset Value (NAV) approach. **A Bank** stated that the Banks in the region are already subjected to large exposure limits of 15% of the capital base. Given the prevailing difficult market environment, any additional deductions due to the proposal to limit the Bank's Qualifying Holdings to 60% of its capital would put severe stress on the capital adequacy of the Bank and could further limit the expansion activities of the Bank. The effects would be particularly severe during these troubled times when liquidity in the market is very tight and the appetite amongst investors is limited.	Disagree- This is a Basel requirement for all banks. The intention of CP-5 is to prevent excessive concentration and to encourage banks to concentrate on their prime role as financial intermediaries providing finance .
4.9 **The CBB may allow the limits in paragraphs 4.7 and 4.8 above to be exceeded, provided that the concerned bank has addressed the points outlined in Section 5 of this paper to the satisfaction of the CBB. Any excesses above the limits in paragraphs 4.7 and 4.8 must be deducted**	**A Bank** stated that Clause 4.9 requires banks to deduct from the capital base any investments in excess of 15% of the holdings in the concerned banks capital base or if the aggregate of such holdings in the other entities exceed 60% of the bank's capital in accordance with the PCD Module of the CBB regulations. The PCD module currently stipulates (clause PCD 2.3.2) deductions on exposures in excess of 15% in case not exempted or grand fathered by CBB or in case of aggregate exposures of all investments in excess of 15% of the bank's capital base in ***commercial entities*** exceed the threshold of 60% of the bank's capital then the excess amount should be deducted from the capital base of the concerned bank. While the current PCD module restricts the 60% threshold to commercial entities only, the proposed regulation does not make any differentiation between investment in financial institutions and investment in commercial	The 60% aggregate limit under this paper is not restricted to commercial entities only. It is for any investment that fall within the definition of Qualifying holding as stipulated in this paper. CP-5 does not differentiate between commercial and financial sector investments.

as per the deduction requirements of Module PCD-2.	entity. A clarification is hence required in this respect. The Bank would also like to highlight that PCD module when adopted followed Basel II guidelines and its provisions represent leading practices. It further assumes that this excludes any exemptions that the CBB has given.	Banks and the CBB will agree on a case-b-case basis on the transitioning of current large investments.
	A Bank inquired: does the circular imply in 4.9, that for exceptional approval of Large Exposure Limit, the new criteria would apply? Does this constitute a change for the Large Exposure Limit rule?	The new limits and criteria apply to qualifying holdings.
	A Bank stated that the limits in 4.7 and 4.8 may be applied retrospectively unless the factors in section 5 have been addressed to the CBB's satisfaction. If the CBB is not so satisfied and the limits are applied retrospectively to an existing investment that had been previously approved by the CBB, what will the practical consequence be? Similar issues to those raised under 4.6(a) above could apply.	All existing qualifying holdings would be grandfathered with respect to the limits outlined in paragraphs 4.7 and 4.8, however, banks will not be allowed to further invest in any new qualifying holdings until they reduce their excessive exposure below these limits.
	A Bank noted that what would be the regularization timeline for already	See the comment above.

	booked investments that exceeds threshold? Will the CBB provide any timeline to regularize this investment or banks will be forced to deduct this investment immediately from capital for capital adequacy purpose?	

5 CBB Criteria for Assessment of Investments and Acquisitions by Locally Incorporated Banks In assessing any proposed investments or acquisitions mentioned in section 4 listed above, the CBB will take into account the following points: a. The amount of the proposed investment relative to the existing capital base of the bank. b. Existing capital adequacy ratios on a solo and on a consolidated basis and forecast ratios after the investment or acquisition has gone ahead. c. Adequacy of reporting lines by the proposed investment or	**A Bank** stated that the CBB criteria for assessment of investments and acquisitions given in section 5 should be specific and the banks should have clear direction about the information to be provided on each qualifying investment in order to avoid delays in the approval process. For example, in the current paper section 5 (d), 5 (f), 5 (g) and 5 (i) are nonspecific. It will be beneficial for the banks if the CBB can design a specific format for each qualifying investment requiring details as to each points mentioned in section 5 of the consultation paper. **A Bank** stated that some of these points might benefit from some clarification: a) It's unlikely the 'investment' or the 'acquisition' will be doing any reporting via reporting lines. The bank might obtain a seat on the target board, in which case the director might report back to the bank, but the target itself will probably just provide whatever information is required by local company law. b) Is this addressing the exchange of information by the host regulator with overseas regulators like the CBB? c) What 'holdings' of other shareholders is this addressing – their holdings in the bank?		Disagree-specific criteria might end up with a 'one size fits all' problem. If a bank acquires a holding and board seat in an entity, it should make sure that it is adequately informed of the financial and governance status of the entity. It would be failing in its fiduciary duty to its shareholders if it did not do so. Where the investment concerns a regulated entity, exchange of information with other regulators is a key issue. Both the bank and the CBB need to be aware of the extent of other shareholders holdings of capital in a target acquisition.

acquisition 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. i. The compliance relationship of the concerned bank with the CBB's rules and	**A Bank** stated that these requirements could mention details related to listing where the target is a listed entity. Point (g) could have an addendum bracket to clarify this is the Central Bank and/or Stock Exchange. **A Bank** stated that 5 (d) mentions that the senior personnel associated with the proposed investment or acquisition, are expected to be 'fit and proper'. Please clarify the list of senior personnel that the CBB has in mind. i.e. is it the Board of Directors of the entity/ investee company, or all the 'controlled' functions of the entity, as currently defined in the rulebook?		Noted. These are the approved persons occupying 'controlled functions' at the investee's company i.e. if they are not fit & proper or there are no designated fit & proper personnel, then the acquisition may be rejected.

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 "qualifying holding" is being acquired. o. The impact and extent of goodwill and intangibles upon the capital adequacy and balance sheet of the bank on a solo and 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).			
6.1 Following receipt of comments on this consultation paper, the CBB will amend and finalise Module CM. The new approval requirements	**Scope of Application:** **A Bank** noted that the regulations should not only exempt existing deals but also any addition thereto subsequently from the proposed approval requirements. **A Bank** noted that Section 6 might create ambiguity and /or potential difficulty to some market participants. If 4.7 and 4.8 are to apply promptly to exiting	The new approval requirements of paragraphs 4.4 to 4.6 will apply promptly for all new investments and acquisitions, but not retroactively to current exposures or investments.	

of paragraphs 4.4 to 4.6 will apply promptly for all new investments and acquisitions, but not retroactively to current exposures or investments. The limits outlined in paragraphs 4.7 and 4.8 will apply promptly to all existing qualifying holdings.	holdings then it would help if some guidance is supplied as to how this will work.	All existing qualifying holdings would be grandfathered with respect to the limits outlined in paragraphs 4.7 and 4.8, however, banks will not be allowed to further invest in any new qualifying holdings until they reduce their excessive exposure below these limits.