Consultation: Basel 3 – Draft Rulebook Module CA Volume 2

Industry Comments and Feedback

May 2014

Industry Comments		
General Comments:	**Ref**	**CBB's Response**
A Bank inquired if there is any reason why there is no reference to a countercyclical buffer or a SIFI buffer.	GR-2	Supervisory arrangements for both are still under internal discussion.
A Bank noted that the proposed changes will further strengthen the existing capital framework and will also increase the ability of banks incorporated in Bahrain to withstand in adverse economic environment.	GR-3	Noted.
A bank noted that the CBB are in the process of drafting and issuing a number of rulebooks in relation to Basel III, examples include the rulebooks on Credit Risk (CM), Prudential Consolidations and Deductions (PCD). The proposed new rulebooks could potentially have an impact on the calculation of capital adequacy of the Bank. The Bank will be in a better position to assess the full impact of the proposed regulations after they receive confirmation on how the proposed new rulebooks are integrated with the CA rulebook and have had the opportunity to review and analyze the same. Nonetheless, the bank is providing their comments on the specific application of the Basel (III) Consultative Document on a standalone basis. Therefore, it is suggested that the Bank be allowed to provide additional comments on the Capital Adequacy (CA) rulebook once the full set it is suggested that all the relevant rulebooks be finalized and issued together, in order for banks to have a holistic view of these interrelated regulations impact their operations, capital, liquidity and other areas. **Large Party Treatment -** All the Large party deductions and reporting should be, if possible, relaxed or aligned with the Basel Committee paper - "Standard Framework for measuring and controlling large exposures" issued in April 2014. It is suggested to use the paper as a basis for the proposed new regulations. **Maximum Loss** – As a general principle, it is recommended that the CBB consider the exposures as the maximum loss that a bank can suffer in case of sudden failure of the counterparty. Therefore, the exposure at risk for capital adequacy and other aspects of regulation should be considered **net** of any available risk mitigation. **Others** In section CA 1.1.11, reference is made to the section CA 7.1.1 which is supposed to link CA 6.1.1. Similarly	GR-4	• The new paper will be consulted in due course and Module CM will be aligned with it. • Agreed, if the mitigant is eligible under Basel 3 and is legally recognised. • Noted and will be

Paragraph CA 9.1.5 refers to CA 9.1.6 which is non-existent. CA 4.2.24 for materiality threshold should be aligned to the CA 4.2.5.		amended where necessary.
An Islamic Institution submitted the following comments: • It is noted that the draft draws heavily on the standards issued in December 2013 by the Islamic Financial Services Board (IFSB) titled "*Revised Capital Adequacy Standard for institutions offering Islamic financial services*' (IFSB-15), and therefore, believe that the revised Module provides level-playing field to Islamic banks. • The regulation is very comprehensive containing well-conceived strong enhancements, and the efforts of the CBB are commendable in this respect. While we broadly concur with the changes, the specific comments are on areas such as: (a) conversion factor under different Capital Adequacy Ratio (CAR); (b) CAR calculation Formula and implications of Alpha; (c) qualifying criteria for adoption of The Standardized Approach for calculating the operational risk capital charge; (d) risk weight implications for the Islamic banks when holding Sukuk rated or unrated; (e) role of restricted Profit Sharing Investment Accounts (PSIA) in CAR and clarification on the usage and implication of restricted PSIAs for real estate. • It was noted that as the Islamic banks identified as Domestic Systemically Important Banks (D-SIBs) by the CBB will be required to hold additional Common Equity Tier 1 (CET1) capital as per Basel III and IFSB-15, it is pertinent to provide a framework for the assessment and additional regulatory requirements for D-SIBs including setting requirements for higher loss absorbency (HLA) and selection of HLA requirement of between 0.5% and 3.5% of CET1 to total risk-weighted assets as set out in IFSB-15. In addition to the HLA requirement for D-SIBs, the CBB may consider the other measures, which can help to strengthen oversight over D-SIBs. • With respect to D-SIBs, the CBB may add one paragraph to elucidate that further guidance will be provided in due course on the application of D-SIBs, similar to leverage. • It is suggested bringing the CA-4 (Credit risk) and CA-5 (Market risk) ahead of presenting the CA-3 as CA-3 includes implications to CA-4 and CA-5. The Islamic banks need to understand first what is credit risk and what are the credit risk mitigation techniques, and also the kinds of market risk and the measurement of market risk, before applying them into specific Islamic financing and investment contracts/assets. It is noted that the components of these Islamic financing and investment contracts/assets include both credit risk and market risk; accordingly, it is important that this Section (CA-3) can be brought later after credit risk and market risk. This will be also consistent with IFSB-15.	GR-5	• Noted. • Noted. • D-SIB supervisory measures are subject to internal discussion. Consultation on D-SIB buffers will proceed in due course. • Noted. • The order reflects the existing order of the Module since 2006. It would be too complicated to reorder chapters now.

A Consultant presented the following brief findings: 1. Both IFSB and Basel II/ III ignores Agricultural Lending / Financing Risk Weights. 2. Both IFSB and Basel II / III does not take Transactional Risk of Sharia Compliant Products and Services into account. 3. Both IFSB and Basel II/ III uses Marked to Market Methodology IMA (Internal Modeling Approach) to calculate Market risk's of trading book transactions. Equity Murabaha (Margin Financing of Capital Market Transactions) and other ST Trades which do not fall within the category of "Trading Book" as their prices either don't exist or are not transparent enough) and / or they are treated as Banking Book Transactions are not assigned a market risk capital charge at the banks to save Risk/ Economic Capital. 4. Credit Risk Capital Charge Treatment of Sharia Complaint OTC Margin Financing Transactions? 5. Capital Charge for Islamic Derivatives? Arboun (Call and Put Option Contigent Claim Contracts) / Islamic Hedge Funds and so on etc. Is not clearly understood and appropriated for by either BASEL or IFSB. 6. Sharia Complaint banks invest in Property Markets! The ICAR- Invested Capital at Risk Charge for property/ physical assets / REITS cannot be calculated under IMA - Pillar 1. 7. On the Liability Side of the Balance Sheet Restricted and Unrestricted Musharaka and Modaraba Accounts are exposed to severe Withdrawal Risks. Islamic Banks should impose a capital charge on risk sensitive liabilities using a Liability side VaR. The two ratios NSFR AND CFR should be adjusted accordingly. 8. Wadhiya'a Yaad Dhamana Accounts should be separated by other deposits accounts. Bank Guaranteed Products have idiosyncratic risk should be stress tested and an additional capital charge should be imposed on banks that guarantee liabilities in one way or the other. 9. Capital Protected Products are offered by many Islamic Banks and thrifts. Such products require a capital charge/ buffer on the Liability side of the Balance Sheet. 10. Reputation and Legal and Sharia Non - Compliance Risks are not quantified as per BASEL II/III. These risks exist on both sides of the balance sheet. 11. No Capital Charge for ETFs - Exchange Traded Funds with multiple sectors. 12. No Capital Charge for Index Tracker Funds with multiple asset classes. 13. No Capital Charge for Fund of Funds with multiple asset classes. 14. No Cross-Asset Class Fund Charges for banks. 15. Interaction between Sharia Compliant Financial Institution specific risks and Conventional Financial Risks not discussed. For E.g. Commercial Displacement Risk.	GR-6	1. Basel 3 does not address industries or sectors.. 2. Yes, they do. Consider CA-3 and CA-4. 3. The CBB has used IFSB treatment. Generally these products would be in the banking book. 4. Not in IFSB. 5. Not in IFSB. 6. See CA-9, CA-4 and CA-3. 7. Liquidity and leverage will be covered later. 8. Guarantees are subject to CA_4 treatment. 9. See point 8 above. 10. The operational risk charge covers this. 11. Treated as funds. 12. Treated as funds.

		13. Treated as funds. 14. Treated as funds. 15. See CAR formula for IRR and PER.

Specific Comments:

Proposed rule	Comments	Ref.	CBB's Response
CA-B.1.2 **Rules in this Module are applicable to <u>Bahraini Islamic bank licensees</u> on both a solo (i.e. including their foreign branches) and on a consolidated group basis as described below. The applicable ratios and methodology are described in this Chapter and Chapters CA-1 and CA-2 for solo and consolidated CAR calculation. Module PCD includes additional; details on consolidation and deduction methodologies.**	**A bank** noted that CA-B.1.2 refers to 'consolidated group basis as described below'. CA-B.1.2A says "*the scope of this Module includes the parent bank and all its banking subsidiaries*". Does this mean that in future the scope of consolidation does not apply to the various <u>non-financial</u> entities a bank may currently populate in its balance sheet?	A-1	Non-financial entities cannot be included in the consolidation process as the activities and assets cannot (easily) be risk-weighted.
CA-B.2.1 **The transitional arrangements for implementing the new standards will help to ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising,**	**A bank** suggested that the CBB should postpone the adoption of the Capital Conservation Buffer CCB limit of 2.5% to 2019, either proportionally application over the period from 2015-2019 or postpone till the full implementation.	B-1	Currently the required CARs are 12.0% and 12.5% (trigger and target). Deferral will not achieve any advantage.
	An Islamic Institution noted that CA-B.2.1 (a) explains the components of Consolidated Capital Adequacy Ratios (CARs) and Solo CARs. The total capital or CAR for Solo is set as 8%, whereas	B-2	This has been a commonly occurring matter. We contacted the Basel

while still supporting lending to the economy. The transitional arrangements are as follows:	Consolidated CAR is set at 10%, with 2% add on. Further, CA-1.1.16, explains how Solo Total risk-weighted assets are determined by the Islamic bank, that is through multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 12.5. This 12.5 conversion factor (which is reciprocal of 8% CAR) is accurate for Solo; however, similar paragraph should be added to indicate how Consolidated Total risk-weighted assets will be determined, that is, through multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 10 conversion factor (which is reciprocal of 10% CAR).		Committee. Their reply was that the 12.5 multiplier is a constant for all CAR calculations. While the multiplier has originally been derived as the reciprocal of the minimum total capital ratio, it is now effectively treated as a constant. In particular, this ensures that there is only one RWA number which feeds into the calculation of CET1, Tier 1 and total capital ratios, with and without the various buffers.
	A Bank noted that according to this rule, the minimum Core Equity Tier 1 (CET1) is set at 6.5% plus an additional 2.5% Capital Conservation Buffer (CCB) which must also be provided as part of the core equity. This raises the overall core equity capital to a minimum of 9% of the overall consolidated capital level starting from January 1 2015. In their opinion, this is a material and significant change in the rules since the issuance of CBB's circular of June 2013 (Ref EDBS/KH/98/2013) which defined a minimum core capital of 4.5%. Given the short time to the implementation date of January 2015 (less than 7 months) it is unlikely that banks will be able to meet this requirement in such a short time. In respect of the above, the following is proposed: • Banks to be given amble time to adjust to this requirement; • The 9% CET1 should be implemented in a phased manner (at least for the Capital conservation buffer) similar to the Basel Committee guidelines.	B-3	See B-1.

CA-1.1.3 **Consolidated Total risk-weighted assets are determined by:** **(a) Multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 12.5 for the <u>Islamic bank licensee</u> and all its consolidated subsidiaries; and** **(b) Adding the resulting figures to the sum of risk-weighted assets for credit risk (see CA-1.1.4) and securitisation risk for the <u>Islamic bank licensee</u> and all its subsidiaries (see CA-1.1.5).**	**A bank** noted that CA 1.1.3 states that for calculating the risk weight, 15% of the average gross income for Operational Risk (Operational Risk Capital requirement) is multiplied by 12.5 under the basic indicator approach. This implies that for 100 (15% of 666.66 average gross income) as the operational risk capital requirement, the bank is essentially keeping (100 * 12.5* 12.5%) 156.25 as the operational risk capital charge. Further, the CA 6.2.4 states that banks are not required to set aside more than 15% of their average last 3 years gross income for operational risk charge under the basic indicator approach. It is suggested that the CBB rationalizes the operational risk capital charge. <u>1. Background to the operational risk methodology and overall summary:</u> The Basic indicator methodology adopted by the Basel Committee is used to calculate the <u>capital charge</u> emanating from the bank's operational risk activities. Since, the capital ratios are calculated using available capital divided by the total risk weighted assets (including operational risk elements), the Basel Committee proposed to apply a multiplier of 12.5 to convert the capital charge into a risk weight equivalent. The 12.5 multiplier reflects the reciprocal of the minimum capital ratio that they have proposed of 8%. This is also detailed in the Basel Committee's paper: "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version" *Paragraph:* *"44. Total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (i.e. the reciprocal of the minimum capital ratio of 8%)"* However, since the CBB is proposing that banks are required to hold a	C-1	There are in fact six minimum ratios varying from 6.5% to 12.5%. It would be impractical to put 6 different multipliers in place it is clear that a consistent multiplier should also be used. The concerned multiplier will remain at 12.5. Basel Reply: While the multiplier has originally been derived as the reciprocal of the minimum total capital ratio, it is now effectively treated as a constant. In particular, this ensures that there is only one RWA number which feeds into the calculation of CET1, Tier 1 and total capital ratios, with and without the various buffers. This approach is also used by countries with higher national minimum requirements (already under Basel II).

	minimum of 12.5% capital ratio – as opposed to the 8% of Basel Committee, the proposed multiplier of 12.5 is not in line with the methodology adopted by the Basel Committee. The capital charge multipliers that convert the capital charge methodologies adopted by Basel Committee to risk weight equivalents should reflect the reciprocal of the minimum required ratios proposed by the CBB. This same logic will also apply to the market risk capital charge and its respective multiplier. **Overall Implications of proposed methodology:** In the instance where the multiplier does not reflect the minimum capital ratio requirements, there will be the following key implications: 1) CAR will be understated by approximately 36% and the total risk weighted assets will be overstated by 56.25%. The example below will illustrate this fact. 2) The CAR calculations and the bank's economic position will be inconsistent and will depict two separate views, one will be that the bank is in compliance with its capital requirements, the second will be that the bank is not in compliance with its CAR ratio. The example below illustrates this point. 3) The inconsistency of the multiplier with the reciprocal of the minimum capital ratio will also have severe dampening effect on the bank's business and profitability growth by having an effective alpha that is above the alpha factor prescribed by the Basel Committee and the CBB. The bank will need to price in the additional operational risk capital charge/alpha factor which will increase its rates offered to customers and put it in a comparative disadvantage to other regional peer banks that do not face this issue. Further, it will also have a direct impact on the cost of funding of the bank's customers as they will now be offered higher financing rates. The example below further illustrates this point.		

	The following is an example that illustrates the inconsistencies of the methodology adopted by the CBB and explains the above issues. 2. Example: Assumptions: • Average gross income of previous three years is 80. • Operational risk capital charge as per Basic Indicator is BD 12 (gross income of 80 * 15% alpha factor prescribed by the CBB and Basel Committee). • Available Capital is BD 12. • No other risks are considered for simplicity purposes. • Minimum capital requirement is 12.5% as prescribed by the CBB. **2. A Scenario 1** (existing treatment): In this scenario, the operational risk multiplier is 12.5 as prescribed by the CBB. **Outcome:** The initial outcome using capital charges and available capital to assess adequacy of capital: The bank initially meets the capital requirements as the capital charge of BD 12 is met exactly with the available capital of BD 12 and there is no shortfall in capital. Hence, the bank is in compliance. The outcome when converting to a CAR ratio: However, for the calculation of CAR, the bank multiplies the 12.5 to the operational risk capital charge and gets an operational risk weighted assets of 150. The CAR ratio will be BD 12 (available capital)/ BD 150 (risk weighted assets with multiplier of 12.5) which is 8% and below the minimum requirement of 12.5% set by the CBB. Hence, the bank is not in compliance with the minimum ratio in this instance. Impact on Alpha factor and business attractiveness: this scenario also shows that the effective alpha factor used to calculate the capital charge		

	is more than the Basel prescribed of 15% for the Basic Indicator approach. This can be explained as follows: • The total risk weighted assets from operational risk is 150 • This means a capital charge of 150 * 12.5% (minimum capital requirement) of 18.75. • Dividing the capital charge by the gross income gets an effective Alpha factor of 23.4% (18.75 / 80) • The effective Alpha factor is above the alpha factor prescribed by the Basel Committee and the CBB as well of 15%. • Hence, for each 1 BD of average gross income, the bank needs to keep an effective alpha factor or capital charge of 23.4% as opposed to 15%. • This treatment will have significant business and pricing implications. The bank will have to effectively carry larger capital requirements and increase its overall pricing offered to its customers to reflect such additional capital charge. This will cause a competitive disadvantage to all banks operating in Bahrain using this methodology where possibly other regional banks will not be subject to such higher effective alpha factor requirements. Overall assessment: This scenario shows that the treatment of using a multiplier of 12.5 is internally inconsistent and shows two separate views to the same economic reality where in one scenario the bank is in compliance and in the other the bank is not in compliance. It also has direct business implications in the bank's pricing decisions and might render it competitively disadvantaged. **2.B Scenario 2:** (bank's proposed methodology and aligning it to Basel Committee). In this scenario, the multiplier should be the		

	reciprocal of the 12.5% minimum requirement which is 8 instead of 12.5. **<u>Outcome:</u>** <u>The initial outcome using capital charges and available capital to assess adequacy of capital:</u> There is no change to the initial outcome as the bank still meets the minimum capital charge of operational risk. Hence, the bank is still in compliance. <u>The outcome when converting to a CAR ratio:</u> In this scenario, the operational risk capital charge is calculated using the reciprocal of 12.5% minimum CAR proposed by the CBB which is 8. The operational risk weighted assets of 96 (12*8). The CAR ratio will be BD 12 (available capital)/ BD 96 (risk weighted assets with multiplier of 8) is 12.5% which means that the bank meets the minimum requirement and reflects the initial economic outcome as well. <u>Impact on Alpha factor and business attractiveness</u>: This scenario will show that the alpha remains unchanged. This can be explained as follows: • The total risk weighted assets from operational risk is 96. • This means a capital charge of 96 * 12.5% (using a minimum capital requirement) of 12. • Dividing the capital charge by the gross income gets an effective Alpha factor of 15% (12 / 80) • The effective Alpha factor is the same as the alpha factor prescribed by the Basel Committee and the CBB as well of 15%. <u>Overall assessment:</u> This scenario shows an internal consistency in all three outcomes and reflects what the Basel Committee initially intended as an appropriate		

	methodology and puts the bank in par with other regional banks in terms of effective capital charge with regards to operational risk.		
CA-1.1.11 **The CBB requires regulatory capital to be held to cater for DCR and the operational risk mentioned in Paragraph CA-7.1.1 in view of the residual risk to the Islamic bank licensee and its shareholders. To be prudent, the CBB requires Islamic bank licensees to provide regulatory capital to cover a minimum requirement arising from 30% of the risk weighted assets and contingencies financed by the UPSIAs. Therefore, for the purpose of calculating its Capital Adequacy Ratio (CAR), the risk-weighted assets of an Islamic bank licensee consist of the sum of the risk-weighted assets financed by the Islamic bank licensee's own capital and liabilities, plus 30% of the risk-weighted assets financed by the Islamic bank licensee's UPSIAs as outlined in Paragraph CA-1.1.12.**	**An Islamic Institution** noted that when mentioning the 30% of the risk to be borne by the Islamic bank, it will be useful if this paragraph can further be enhanced by saying that this risk transfer mechanism is denoted by "Alpha", which is the proportion of risk-weighted assets that needs to be included in the CAR to cater for the transfer of risk from Investment Account Holders (IAH) to the Islamic bank.	D-1	Agree. This will be identified as 'alpha'.
CA-1.1.12 **For the purpose of this module the consolidated CAR is calculated by applying the Total**	**A Bank** noted that in the revised rules, the impact of PER and IRR is incorporated in the denominator of capital adequacy formula. For avoidance of misinterpretation, this requirement needs further clarification as to whether the total amount of PER and IRR of UPSIA	E-1	PER & IRR are deducted against the concerned UPSIA because they are created as a result of the

Capital (as defined in Paragraph CA-1.1.2) to the numerator and risk-weighted assets (RWAs) as defined in Paragraph CA-1.1.3) to the denominator as shown below. **Total Capital**	**or** RWA funded by PER and IRR of UPSIA is deducted from total UPSIA funded RWA. Further, the adjustment in the formula doesn't account for PER share of mudarib. Although PER is a reserve utilized to smoothen the profit payout (i.e. not directly linked to cover asset losses), banks should be given the benefit of incorporating the same in, at least, T2 capital. The exclusion of this may incline banks toward creating general provisions (which is eligible for T2 capital) rather than PER.		UPSIA. Provisions are created against expected or incurred loss..
{Self-financed RWAs (Credit + Market Risks) + Operational Risks Plus **∝ [RWAs funded by UPSIAs[a] (Credit + Market Risks) - PER and IRR of UPSIAs]}** **(a) Where the funds are commingled, the RWA funded by UPSIA are calculated based on their pro-rata share of the relevant assets.** **(b) ∝ refers to the proportion assets funded by UPSIA which, as determined by the CBB, is 30%; and** **(c) The UPSIAs' share of PER and by IRR is deducted from the total RWAs funded by the UPSIAs. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any**	**An Islamic Institution** noted that although, the given formula intends to achieve similar outcome compared to using the similar IFSB-15 Supervisory Discretion Formula; nevertheless, it will be more useful and valuable retaining similar language and formula used in IFSB-15 for measuring the CAR under Supervisory Discretion Formula as the approach to measure the risks (such as credit, market, and operational risks) in CAR, and adjustment to the capital ratio denominator for Alpha factor (under Unrestricted Profit Sharing Investment Accounts (UPSIA)) will be undertaken by the Islamic bank as per IFSB-15 as indicated in the regulation. Therefore, this will bring more consistency in the calculations and understanding in the adjustment of Alpha needed to calculate CAR. There is also need to clarify that this formula does not assume commingling of funds of Restricted Profit Sharing Investment Accounts, and therefore, it is not reflected in the formula.	E-2	The CBB has simplified the formula for ease of calculation. Agree. RIAs are not included in the formula and the formula assumes no commingling.

future losses on the investment financed by the PSIA. This formula is applicable as the Islamic bank licensees may smooth income to the UPSIAs as a mechanism to minimise withdrawal risk.			
CA-1.1.13 All transactions, including forward sales and purchases, must be included in the calculation of capital requirements as from the date on which they were entered into. Although regular reporting takes place quarterly, Islamic bank licensees are required to manage their risks in such a way that the capital and leverage requirements are being met on a continuous basis, i.e. at the close of each business day. Islamic bank licensees must not "window-dress" by showing significantly lower credit or market risk positions on reporting dates. Islamic bank licensees must maintain strict risk management systems to ensure that intra-day exposures are not excessive. If an Islamic bank licensee fails to meet the capital requirements of this	**A bank** recommended that instead of requiring verification of daily compliance with Capital requirements by independent risk management and internal auditors, the rulebook should require independent risk management and internal audit should verify that robust internal processes are in place to assure the CBB with daily compliance of Capital requirements.	F-1	Disagree. This is an existing requirement and is also in Basel 2 (p701vi).

Module, the Islamic bank licensee must take immediate measures to rectify the situation as detailed in Section CA-1.2.			
CA-1.1.17 **For the purpose of this module the solo CAR is calculated by applying the Solo Total Capital (as defined in Paragraph CA-1.1.15) to the numerator and solo risk-weighted assets (RWAs) as defined in Paragraph CA-1.1.16) to the denominator as shown below.** $$\frac{\textbf{Total Capital}}{\{\textbf{Self-financed RWAs (Credit + Market Risks) + Operational Risks}\ \textbf{Plus}\ \alpha\,[\textbf{RWAs funded by UPSIAs}^{a}\ \textbf{(Credit + Market Risks) - PER and IRR of UPSIAs}]\}}$$ **(a) Where the funds are commingled, the RWA funded by UPSIA are calculated based on their pro-rata share of the relevant assets.** **(b) α refers to the proportion**	**An Islamic Institution** noted that the Formula in CA-1.1.17 and in CA-1.1.12 appears to be same. It may be appropriate to delete one to avoid redundancy, and the guidance for measurement of both Solo and Consolidated CAR can be merged together under CA-1.1.12. Just like other appendices, it will be equally significant for Islamic banks to have one Appendix on the usage of CAR formula, which reflects the risk sharing mechanism and implications of the adjustment to denominator for CAR of Islamic banks.	G-1	Disagree. CA-1.15 shows that investments in subsidiaries must be deducted. C-1.1.16 shows equivalent deduction of assets of subsidiaries.

assets funded by UPSIA which, as determined by the CBB, is 30%; and (c) The UPSIAs' share of PER and by IRR is deducted from the total RWAs funded by the UPSIAs. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any future losses on the investment financed by the PSIA. This formula is applicable as the Islamic bank licensees may smooth income to the UPSIAs as a mechanism to minimise withdrawal risk.			
CA-1.3.4 Islamic bank licensees' daily compliance with the capital requirements for credit and market risk must be verified by the independent risk management department and the internal auditor.	**A bank** noted that it would be possible to estimate with reasonable assurance that there is no breach of the capital requirements on daily basis but verification on daily basis by independent function is a difficult task especially in cases where subsidiaries data needed to calculate consolidated CAR position. It is suggested that the wordings of this rule should be changed to reflect that Islamic bank licensees should monitor and comply with capital requirements on daily basis.	H-1	Disagree. See F-1.
	A bank noted that it will not be practical to carry out daily calculation for the ratios especially for a banking group like their bank. Alternatively, it is suggested putting in place the necessary procedures and control to report to CBB immediately any incidents that would affect the capital adequacy ratios of the Islamic bank licensee and being verified by independent risk management department and	H-2	Disagree. See F-1.

	internal auditor accordingly.		
CA-2.1.10 **For an instrument to be included in T2 capital (see CA-2.1.8(a)), it must meet all the criteria below:** **(j) Subject to Shari'a compliance, an Islamic bank licensee can issue T2 capital instruments in the form of Mudarabah or Wakalah Sukuk, which would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. It is essential that the terms of conversion, notably the trigger event and the conversion ratio, are clearly specified in the Sukuk contract so as to avoid gharar. Prior to conversion, the underlying assets of such Sukuk would not be available to meet the claims of the Islamic bank licensee's current account holders or other creditors. After conversion of the Sukuk in case of the Islamic bank licensee's non-viability or insolvency, T2 capital would rank pari passu with CET1, along with AT1 capital.**	**A bank** suggested that the rulebook should define the point of non-viability (PONV) clause for Tier 2 Capital as well. The definition of Tier 2 capital as defined in CA-2.1.10 only includes a reference to the instruments that are in the form of Mudaraba or Wakala Sukuk. It is suggested that the CBB explicitly includes all other forms of appropriate Islamic contracts including Murabaha contracts which could be used to raise Tier 2 capital as long as the eligibility requirements of Tier 2 capital are satisfied.	I-1	Agree. This will be added to the next version. Such contracts were not considered eligible by IFSB.
	An Islamic Institution noted that in subparagraph (j), it is proposed to remove **"in the form of Mudarabah or Wakalah"** since the paragraph already states that the issuance must be subject to Shari'a compliance. This will follow BCBS approach for not specifying the types of instrument structures and therefore giving similar flexibility to Islamic banks subject in all cases to Shari'a compliance.	I-2	IFSB identified only these two types of instruments as eligible. See I-1 above.

CA-2.1.11 Profit-sharing investment accounts of an Islamic bank licensee are not classified as part of the Islamic bank licensee's capital because they do not meet the above-mentioned criteria of T1 or T2 Capital. Furthermore, all the investment risk reserve (IRR) and a portion of the profit equalisation reserve (PER) belong to the equity of investment account holders, and thus are not part of the capital of the Islamic bank licensee. As the purpose of a PER is to smooth the profit payouts and not to cover losses, any portion of a PER that is part of the Islamic bank licensee's reserves should also not be treated as part of the regulatory capital of the Islamic bank licensee. The impact of PER and IRR has already been incorporated in the alpha component of the denominator of the formula for the calculation of the CAR, as outlined in CA-1.1.12 of this Module.	**An Islamic Institution** noted that apart from mentioning that all the investment risk reserve (IRR) and a portion of the profit equalisation reserve (PER) belong to the equity of investment account holders, and thus are not part of the capital of the Islamic bank licensee; it is suggested to add that PER and IRR are not considered part of the capital because they may not meet the conditions or criteria that are necessary for being capital for the Islamic bank.	J-1	Agreed. This is actually stated in this paragraph (highlighted).
	A Bank noted that in this revised version (which are adopted from IFSB 15), the treatment of Investment Risk Reserves (IRR) and Profit Equalization Reserves (PER) are not allowed to be included as part of Tier 2 capital of the Bank. This provision may lead to a further strain on the capital adequacy level of Islamic banks in Bahrain as currently the CBB rulebook permits the inclusion of PER and IRR in tier 2 capital albeit with certain maximum limits.	J-2	See CAR calculation. The two reserves may be used to adjust RWAs because they are not considered as capital reserves.
	A bank noted that Islamic banks will be put on a disadvantage position if IRR is not allowed to be included in Tier 2 capital. It is suggested that IRR should be allowed to include in Tier 2 capital as per current practice.	J-3	See J-2.

CA-2.2.1 **CAR components and CARs outlined in Paragraph CA-B.2.1 must meet or exceed the following minimum ratios on a consolidated basis relative to total risk-weighted assets:** **a) CET1 must be at least 6.5% of risk-weighted assets at all times;** **b) T1 Capital must be at least 8% of risk-weighted assets at all times;** **c) Total Capital (T1 Capital plus T2 Capital) must be at least 10% of risk-weighted assets at all times;** **d) In addition, Islamic bank licensees must meet the minimum Capital Conservation Buffer (CCB) requirement of 2.5% of risk-weighted assets. The CCB must be composed of CET1 and so this gives an aggregate 9% CET1 including the CCB minimum capital requirement;** **e) A minimum 10.5% T1 Capital Adequacy Ratio including the above CCB requirement; and** **f) A 12.5% minimum Total**	**A bank** suggested that implementation of CCB framework should be gradual and banks should be allowed to build up capital conservation buffer in a phased manner starting from the year 2015 till 2019. **A bank** suggested to implement this buffer during a transition period of three years as the practice is in other jurisdictions.	K-1	See B-1.

Capital Adequacy Ratio including the above CCB requirement.			
CA-2.2.4 **The contribution of T2 capital towards the Minimum Total Capital Ratios and Minimum Total Capital plus Capital Conservation Buffer Ratios mentioned in Paragraphs CA-2.2.1 (consolidated) and CA-2.2.1A (solo) is limited to 2.0%. Also T2 instruments may not exceed 50% of CET1 Capital, once the Minimum Total Capital Ratios mentioned in CA-2.1.1 and CA-2.2.1A have been exceeded. Any T2 in excess of 50% of CET1 will not be eligible to be included in Total Capita1 for the purpose of this Module.**	**A bank** suggested that the limit should include CCB to all Capital levels.	L-1	This is not allowed by Basel 3.
	A bank noted that keeping in view the future plans and current trends to capital planning of Islamic banks, the Tier 2 capital should be admitted up to 2.5% of RWA. **A bank** suggested increasing the percentage to 2.5% in order to encourage Islamic banks to take benefit of this option especially after new capital requirements imposed by Basel 3 which will put banks under pressure to either increase their capital or look for other options including for tier 2 capital.	L-2	Only 2% is allowed to contribute to the minimum total CAR by Basel 3.
CA-2.3.1 **In order for minority interest arising from the issue of common shares by a fully consolidated subsidiary of the <u>Islamic bank licensee</u> to be recognised in CET1 for the consolidated CAR calculation, it must meet the following criteria:** **(a) The instrument giving rise**	**A bank** noted that the CBB only allow the minority arising from the consolidation of Banking subsidiary to be included in CET1. It is suggested to include all the regulated financial subsidiaries, not necessarily a Bank.	M-1	Disagree. Only bank capital may be allowed to contribute to consolidated Total Capital.

to the minority interest would, if issued by the Islamic bank licensee, meet all of the criteria for classification as common shares for regulatory capital purposes; and (b) The subsidiary that issued the instrument is itself a bank[1,2].			
CA-2.3.2 **The amount of minority interest meeting the criteria above that will be recognised in consolidated CET1 will be calculated as follows:** **(a) Total minority interest meeting the two criteria in Paragraph CA-2.3.1 minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders;** **(b) Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of:** **(i) The minimum CET1**	**A Bank** noted that in calculation of cap of minority interest of subsidiaries as part of core capital of the banks, a maximum percentage of 7% of RWA i.e. minimum of 4.5% of core capital plus 2.5% of conservation buffer is utilized. However, minimum core capital requirements may vary as per the local supervisory rules for any subsidiary. This section needs to be elaborated whether these minimum capital requirements are applicable to all subsidiaries irrespective of the minimum capital requirements set by their respective local regulators. Further, it is also not clear whether in case of applying the "Aggregation Approach" as per PCD rulebooks, banks are required to observe the maximum cap of minority share or not.	N-1	The consolidated minimum CET1 requirement in point (ii) will be amended to 9% RWAs.

[1] For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.

[2] Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.

requirement of the subsidiary plus the capital conservation buffer (CCB) (i.e. 7.0% of risk weighted assets); and (ii) The portion of the consolidated minimum CET1 requirement plus the CCB (i.e. 7.0% of consolidated risk weighted assets) that relates to the subsidiary; and (c) The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.			
CA-2.4.16 The regulatory adjustment described in Paragraph CA-2.4.17 applies to investments in the capital of banking, financial and Takaful entities that are outside the scope of regulatory consolidation and where the Islamic bank licensee does not own more than 10% of the issued common share capital of the entity. In addition:	**A bank** suggested increasing the period of the underwriting position to more than 5 business working day for the investment in shares. Same comment for rule CA-2.4.20.	O-1	Five days is all that is allowed under Basel 3.

(a) Investments include direct and indirect[3] holdings of capital instruments. For example, <u>Islamic bank licensees</u> must look through holdings of index securities to determine their underlying holdings of capital;[4] **(b) Holdings in both the banking book and trading book must be included. Capital includes common stock and all other types of capital instruments. It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year);** **(c) Underwriting positions held for five working days or**			

[3] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

4 If banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions as a result of their holdings of index securities, banks must risk weight all such holdings in funds at 1,250% as per the 'fall-back approach' outlined in the Basel Committee document "Capital requirements for banks' equity investments in funds - final standard" dated December 2013.

less can be excluded. Underwriting positions held for longer than five working days must be included; and (d) If the capital instrument of the entity in which the Islamic bank licensee has invested does not meet the criteria for CET1, AT1, or T2 (see CA-2.1.2(f)) of the concerned bank, the capital is to be considered common shares for the purposes of this regulatory adjustment. However, if the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant jurisdiction of the financial entity, it is not required to be deducted.			
CA-2.4.25 The following items receive a 1250% risk weight: (a) Certain securitisation and Sukuk exposures outlined in Chapter CA-8; (b) Non-payment/delivery on non-DvP and non-PvP transactions (see Appendix CA-4); and (c) Significant investments	**A Bank** inquired whether the risk weight of 1,250% applies on the excess amount over the maximum SOL or the total investment in commercial entity? The bank suggests the former.	P-1	The rule will be amended. For any exposure (e.g. significant investment in commercial entities, credit / loans and advances exposures) exceeding the 15% large exposure limit, the excess amount will be, risk weighted at 800%. However the other types of exposures mentioned in

in commercial entities above the materiality thresholds. The materiality thresholds for these investments are: 15% of Total Regulatory Capital for individual significant investments; and 60% of Total Regulatory Capital for the aggregate of such investments. Please refer to Paragraph CA-2.4.20 for the thresholds for individual 'significant' investments for the purpose of this paragraph (i.e. a holding of 10% or more of the equity in a commercial equity).			points (a) and (b) will remain risk weighted at 1250%.
	A bank noted the following points: 1. Definition of 'Significant Investments in Commercial Entities': The proposed guideline defines significant investment as any investment in the equity of a commercial entity of more than 10% of the entity's equity, whereas, the existing CM rulebook paragraph CM 4.4.1E in relation to Qualifying Holding defines it as equity investments that are more than 10% of the Bank's available capital. The relevant factor from the capital adequacy purpose and also for deduction for large party or significant investments should be the percentage of a bank's capital in the commercial entity as opposed to the percentage holding of the capital of the commercial entity. The characteristics of Islamic banks and the corresponding Shariah compliance related issues result in Islamic banks have a predisposition towards holding majority or large stakes in the commercial entities in order to control Investee company's activities as per Shariah requirements. Changing the definition of "Significant Investments" will starve the existing holdings of the commercial entities of any future capital and funding support. Further, it will likely force many Islamic Banks to divest their current holdings in commercial entities and the divested entities may not be readily taken up by other investors. These commercial entities, mainly in the field of real estate and infrastructure, rely heavily on the funding support from Islamic banks. Further, these companies are one of main drivers of incremental growth in Bahrain. They note that growth in Bahrain is still nascent and fragile after the recent economic and political crisis and this regulation might have a detrimental effect on the economy and employment.	P-2	1. These are Basel rules and may not be altered except to make them tougher. Module CM will also need equivalent changes. This is required by Basel and the IFSB in order to encourage banks to concentrate on their primary role as providers of credit rather than investors on own account or using short-term liabilities to fund long-term equity investments.

	2. Limit of 15% for single exposure: The Basel committee has issued the "Standard Framework for measuring and controlling large exposures" for significant exposures in commercial entities. The rule specifies that: "*The sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank's available eligible capital base (Tier 1 Capital in this case) at all times.*" It is suggested that the CBB should align the proposed limits with the Basel Committee recommendations and allow higher limits. Further, such limits should also be a function of the solvency and strength of the company. As strong companies are less likely to fail, they will require less capital allocation or prudential deductions of capital from the bank's capital base. A "one size fits all" principle of limit and deductions of capital against single exposure or large party without any consideration of the strength of the company will prevent profitable and strong companies from contributing to the economic growth of Bahrain, which would have a detrimental impact on the current fledgling growth of the country. Islamic banks in the last decade have contributed significantly to the landscape and economy of Bahrain with flagship projects and developments. Such limits will have an immediate effect on the future growth of these companies and their contribution to the economy.		2. For later consultation.
	3. Risk Weight of 1250%: The maximum capital which should be kept for any exposure over the limits should be limited to 100% of the excess exposure above the limit. Hence the corresponding risk weight should be 800%		3. See comment P-1 above. This is the Basel Committee response:

	against the minimum CAR of 12.5%. Keeping 12.5% minimum capital on 1250% risk weight implies that for every dollar of extra exposure above the limit, the bank will be required to keep 1.56 (1250% *12.5%) dollar of capital, which is excessively penalizing. The risk weight of 1250% should be applicable to the jurisdictions where the minimum capital requirement is 8% in line with the Basel principles. Further, the Basel Committee recommendations are appropriate for banks in developed countries subject to very high leverage with relatively low capital with respect to their assets. However, the majority of the local banks in Bahrain, especially Islamic banks, operate at a very low leverage level with significantly high capital in relation to their total assets. All other references, such as CA 4.2.27 should be aligned to this. 4. Aggregate limits of 60% for significant investments: It should be highlighted that Basel committee paper "Standard Framework for measuring and controlling large exposures" does not specify any aggregate exposure limits. The aggregate limits imply that all the entities are likely to default simultaneously, which is highly unlikely.Simply aggregating investments together ignores any diversification benefits in banks' investment portfolio as those emanating from exposures in different geographies, sectors and others.		While the multiplier has originally been derived as the reciprocal of the minimum total capital ratio, it is now effectively treated as a constant. In particular, this ensures that there is only one RWA number which feeds into the calculation of CET1, Tier 1 and total capital ratios, with and without the various buffers. 4. Basel 2 (and Basel 3 by default) set the 60% limit. See paragraph 35 of Basel 2 and paragraph 47 of Basel 3
	A Bank has noted following two observations: a) The list includes significant investments in commercial entities along with applicable materiality thresholds. However, other exposures covered in CM module of CBB rulebook such as single obligor limits, connected party exposure limits exceeding which requires capital deductions, has not been covered. It is important that the rule should clarify whether such exposures are subject to deductions or risk weighing at 1250%. Treatment of "compliant exposures" as defined in the PCD should also be clarified.	P-3	a) This will be done as part of the alignment of CM with CA.

<table>
<tr><td></td><td>b) The applicable RW rate of 1250% is actually the reciprocal of 8% minimum capital charge. In case of CBB where the minimum capital adequacy ratio is 12.5% at a consolidated level, the applicable RW rate would be 800%. Banks will be further penalized by if required to apply a risk weight of 1250% at a consolidated level on the items which currently require to be deducted.</td><td></td><td>b) See comment P-1 above.</td></tr>
<tr><td>CA-2A.1.2
Outside of periods of stress, <u>Islamic bank licensees</u> must hold buffers of capital above the regulatory minimum.</td><td>A bank noted that the period of stress or what constitutes stress should be clearly defined.</td><td>Q-1</td><td>This can be announced by the CBB as required.</td></tr>
<tr><td>CA-3.11.10
The following table delineates the applicable stage of the CMLF and CMF on the asset side and associated capital charges.
<table>
<tr><th colspan="2">Applicable Stage of the Contract</th><th>Credit RW</th><th>Mkt Risk Capital Charge</th></tr>
<tr><td>1</td><td>Commodities on banks' balance sheet for sale</td><td>Total acquisition cost to the banks for the purchase of commod</td><td>NA*</td></tr>
</table></td><td>A bank noted that their understanding for CA-3.11.10 is that there will be no credit risk weight for Restricted investment accounts that has commodity as underlying contracts as they are off balance sheet items, please let us know otherwise.</td><td>R-1</td><td>The treatment is as shown. Citi are correct where the bank is acting as wakheel or mudarib.</td></tr>
</table>

		ities, less the market value of the commodities as collateral, subject to any haircut and specific provisions.				
2	Commodities sold & delivered to the customer	Based on counterparty's rating or 100% RW for unrated customer.	NA			
CA-4.2.24 Investments in listed equities below the thresholds mentioned in Chapter CA-2 must be risk weighted at 100% while unlisted equities must be risk weighted at 150% provided they are not deducted from capital base or				**A Bank** noted that the revised CA module applies the capital charge calculation method based on the underlying nature of the contracts and assets in case of Musharakah and Mudarabah equity position. For example, investments through Musharakah and Mudarabah vehicles into a private commercial entity to undertake a business venture, either the simple RW method of 400%, if unlisted, or supervisory slotting method is applied to arrive at the risk charge.	S-1	

subject to regulatory adjustments and haircuts as outlined in Chapter CA-2. Significant investments in commercial entities above the 15% and 60% CET1 materiality thresholds (see CA-2.4.25) must be weighted at 1,250%. Significant investments in the common shares of unconsolidated financial institutions and Mortgage Servicing Rights and Deferred tax Assets arising from temporary differences must be risk weighted at 250% if they have not already been deducted from CET1 as required by Paragraphs CA-2.4.20 to CA-2.4.24. For risk-weighting of Sukuk, refer to Chapter CA-8.	For example, the rule requires banks to apply a simple RW of 400% for unlisted investments through Musharakah and Mudarabah vehicles into a private commercial entity or supervisory slotting method is applied to arrive at the risk charge. However, section CA-4.2.24 narrates the RW of investment in equities and funds as 100% and 150% for listed and un-listed equities and funds respectively. Further section CA-4.2.26 of the module explains that the simple approach, discussed in Mudarabah and Musharakah contracts, will be applied only when CBB requires the Islamic bank licensees to do so. The applicable sections shall need to be clarified whether the banks are required to look through the musharakah and mudarabah contracts in order to apply the required simple or slotting approach or section CA-4.2.24 is applicable for all investments in equities and funds. Applying the simple approach with a RW of 400%, applicable in case of an un-listed equity, will be very high to maintain the revised capital adequacy level keeping in mind the business models of Islamic banks. Further, application of these provisions will result in a level playing field not being maintained for Islamic Bank as compared to conventional banks as there is no such high RW applicable in case of volume 1 of CA module.		This is at the choice of the bank with the consent of the CBB on a case by case basis. This charge is set by IFSB.
CA-4.2.27 **See Chapter CA-9 for full details. All direct holdings of real estate by <u>Islamic bank licensees</u> (i.e. owned directly by the <u>Islamic bank licensee</u> on balance sheet) must be weighted at 200%. Premises occupied by the**	**A Bank** noted that all direct real estate holding by Islamic banks must be risk weighted at RW 200% while indirect Investments, through subsidiaries and funds, in real estate companies must be risk weighted at 300% and 400%. The RW of 400% for real estate investment through joint venture or equity participation would be too high and Islamic banks will be under severe pressure as compared to conventional banks where no such high risk charge is applied as per section CA-3.2.29 of volume 1 for conventional banks.	T-1	This is set by IFSB.

<u>Islamic bank licensee</u> must be risk-weighted at 100%. Investments in Real Estate Companies (by way of investments in subsidiaries or associates or other arrangements such as trusts, funds or REITs) must be risk-weighted at 300% or 400% as outlined in Chapter 9 of this Module. Such equity investments will be subject to the materiality thresholds for commercial companies described in CA-2.4.25 and Module PCD and therefore any holdings which amount to 15% or more of regulatory capital will be subject to a 1250% risk weight.	**A bank** noted that due to the specific characteristics of Islamic banks and related Sharia compliance issues, Islamic banks are more likely to invest in real estate companies. Many of the large scale projects which have shaped the current landscape of Bahrain are financed by Islamic banks. Further, many real estate companies are also developers of affordable housing requirements of the Kingdom of Bahrain. Such high risk weighting will discourage and starve such real estate development companies from supporting such socially desirable projects and needs. Further, it is noted that risk weighting of investments in real estate companies, both listed and unlisted are not in line with the risk weighting of those in listed and unlisted equity. It can be safely argued that many of listed (not heavily traded or penny stocks) and unlisted equity expose the banks to greater risk as compared to investing in the real estate companies. This further implies that the real estate in general is a very risky asset class which is a bias originating from countries which allowed prolific credit and investment growth with no or little positive equity stake from its customers and with no appropriate due diligence and suffered as a result. Hence, it is recommended that current risk weighting of 200% should continue.	T-2	These weights are set by IFSB.
CA-3.5.15 **In addition to credit risk mentioned in Paragraphs CA-3.5.12 and CA-3.5.13, the capital requirement for IMB is based on the following two components:** **(a) Total estimated future Ijara receivable amount over the duration of the lease contract: This exposure is mitigated by the market value of the leased asset**	**A bank** noted that the proposed rule implies that the total estimated future Ijara receivable amount over the duration of the lease contract should also be included as a part of a bank's exposure and capital should be maintained for the same. In their view, the exposure for all regulatory and reporting purposes should only be the current exposure value as booked in the bank's balance sheet and not the future deferred profits. As per the CBB Rulebook CM 7.6.2 and relevant accounting norms, the bank is not allowed to recognize future deferred Ijara receivables in its book and if clients opt for an early settlement, the bank can't claim the total estimated future Ijara receivable amount from its customer.	U-1	This is set by IFSB-15. Disagree. CM-7.6.2 simply states how a bank applies fees to early settlement. Agree with the point that if clients opt for an early settlement, the bank can't claim the total estimated future Ijara receivable amount from its customer.

which may be repossessed. The net credit risk exposure must be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the CBB. In cases where the lessee is unrated, a RW of 100% applies after deduction of the value of the leased asset as collateral (subject to any haircut). (See Section CA-4.7); and **(b) Price risk attached to the expected residual fair value of a leased asset: This exposure is treated under Paragraph CA-3.5.201.**			
CA-5.3.1 The minimum capital requirement for equities is expressed in terms of two separately calculated charges, one relating to the "specific risk" of holding a long position in an individual equity, and the other to the "general market risk" of holding a long position in the market as a whole. Where the bank has invested in shares/units of equity funds on Mudaraba financing and the bank has direct exposures in the equities which are traded in a recognised stock exchange, the shares/units are	**An Islamic Institution** suggested replacing the word "bank" with "Islamic bank licensee" in the introduction paragraph for "Equity position risk". The same comment, applies elsewhere, for consistency purposes.	V-1	Agreed.

<table>
<tr><td>considered to be subject to equity risk. The equity position would be considered to be the net asset value as at the reporting date.</td><td></td><td></td><td></td></tr>
<tr><td>CA-5.4.2
The capital charge for specific risk covers the possibility of an adverse movement in the price of a Sukūk held for trading due to factors related to an individual issuer. Offsetting is restricted only to matched positions in the identical issues. No offsetting will be permitted between different issues even if the issuer is the same, since differences in features of Sukūk with respect to profit rates, liquidity and call features, etc. would imply that prices may diverge in the short run. In the case of Sukuk in the trading book, the specific risk charge must be provided on the RW of the issue and the term to maturity of the Sukuk, as follows:
<table><tr><th>Catego s</th><th>External cre assessment</th><th>Specific risk capital charge</th></tr><tr><td>Gov'</td><td>AAA to AA-</td><td>0%</td></tr></table></td><td>An Islamic Institution noted under Government (including GCC governments), external credit assessment category (A+ to BBB-), it is suggested to include “1.60% (residual term to final maturity >24 months)” as this seems to be missing in table. This will be consistent with IFSB-15, para 225.</td><td>W-1</td><td>Disagree. It is already included in the draft rule.</td></tr>
</table>

t (including GCC gov'ts)	A+ to BBB-	0.25% (residual term to final maturity 6 months or less) 1.00% (residual
	BB+ to B-	8.00%
	Below B-	12.00%
	Unrated	8.00%
Investnt Gra		0.25% (residual term to final maturity 6 months or less) 1.00% (residual term to final maturity greater than 6 and up to and including 24 months) 1.60% (residual term to final maturity exceeding 24 months)
Other		
	BB+ to BB-	8.00%
	Below BB-	12.00%
	Unrated	12.00%

CA-5.6.10 **The steps in the calculation of**	**An Islamic Institution** noted under the maturity ladder approach, the net positions are entered into seven time bands, however, the table	X-1	This is the same as IFSB paragraph 24.

the commodities risk by the maturity ladder approach are: **(a) The net positions in individual commodities, expressed in terms of the standard unit of measurement, are first slotted into the maturity ladder. Physical stocks are allocated to the first-time band. A separate maturity ladder is used for each commodity; and** **(b) The sum of short and long positions in the same time-band that are matched is multiplied first by the spot price of the commodity, and then by the spread rate of 1.5% for each time-band as set out in the table below. This represents the capital charge in order to capture all risks within a time-band (which, together, are sometimes referred to as curvature risk).** Time band[5] 0-1 months	presented in CA-5.6.10 (b), does not include serial numbers. It is suggested to add one column and reduce the distance in the time band and months/years.		

[5] Instruments, where the maturity is on the boundary of two maturity time-bands, should be placed into the earlier maturity band. For example, instruments with a maturity of exactly one-year are placed into the 6 to 12 months time-band.

1-3 months 3-6 months 6-12 months 1-2 years 2-3 years over 3 years			
CA-6.1.1 <u>Operational risk</u> is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events which includes but is not limited to, legal risk and Sharia compliance risk. This definition excludes strategic and reputational risk.	**An Islamic Institution** noted that in the definition, the reference to "Shariah compliance risk" should be deleted and replaced with "Shariah non-compliance risk", as compliance with Shariah is not a risk, but non-compliance to Shariah rules and principles, is a risk, which should be reflected. This amendment will be also consistent with CA-6.1.2 and CA-6.1.3(b).	Y-1	Agreed.
CA-6.2.8 **In the Standardised Approach, banks' activities are divided into eight business lines: corporate finance, trading & sales, retail banking, commercial banking, payment & settlement, agency services, asset management, and retail brokerage. The business lines are defined in detail in Appendix CA-4. The <u>Islamic bank licensee</u> must meet the requirements detailed in Section OM-8.3 to qualify for the use of**	**An Islamic Institution** noted that the document should also include the qualifying criteria for adoption of The standardized Approach (TSA) for calculating the operational risk capital charge. With reference to qualifying criteria, in particular for the use of TSA as outlined in IFSB-15 and presented in CA-6.2.8, a reference should be made to paragraphs 660-663 of BCBS International Convergence of Capital Measurement and Capital Standards, June 2006 as IFSB-15, does not explain the qualifying criteria of TSA.	Z-1	There is cross-reference to section OM-8.3 where the criteria are outlined.

standardised approach.			
CA-8.2.2 An <u>Islamic bank licensee</u> may act as originator of Sukuk issues where the ownership of assets held by the <u>Islamic bank licensee</u> is transferred to holders of Sukuk by means of a securitisation. Such a securitisation may offer the <u>Islamic bank licensee</u> one or more of the following benefits: (a) Increased liquidity, since a relatively illiquid asset (such as an asset held as lessor in an Ijara or Ijara Muntahia Bittamlīk) is converted into cash paid by the investors in the Sukuk subscription; and/ or (b) Reduced capital requirements, insofar as the securitisation may permit the issuing <u>Islamic bank licensee</u> to exclude the assets from the calculation of its RWAs.	**An Islamic Institution** noted that the CBB may consider amending the two bullets (a) and (b) as follows: a. *increased liquidity*, since a relatively illiquid asset is converted into cash paid by the investors in the *Sukūk*; and/or b. *reduced capital requirements*, provided the securitisation meets the conditions under which assets may be derecognised for capital adequacy purposes.	AA-1	The suggestions are not material.
CA-8.2.23 **<u>Islamic bank licensees</u> must carry out the credit analysis of their securitisation exposure based on the following criteria, in order to be allowed to use the risk weights in Section CA-8.3. If an <u>Islamic bank licensee</u> is unable to perform the due diligence and maintain the information specified in this paragraph, it will be required to**	**An Islamic Institution** noted that the CBB may consider adding the following example in the Clean-up call option after the first sentence or at the end of the paragraph. For example, this would apply when the underlying assets are IMB assets, the lease payments made by the lessee contain a purchase or capital element, and a number of lease payments remain to be made.	AB-1	This is referred to CA-8.2.21 but is not material.

deduct the securitisation exposure from its regulatory capital. The criteria are applicable to securitisation exposures of Islamic bank licensees both in the banking and trading book: (a) An Islamic bank licensee must have a clear understanding of the nature and features of its individual securitisation exposures, including the risk characteristics of the pools underlying such exposure on an ongoing basis. This requirement applies to both on- and off-balance sheet securitisation exposures; (b) As the payments to Sukuk holders are dependent on the performance of underlying assets, an Islamic bank licensee must be able to assess the performance information on an ongoing basis; and (c) An Islamic bank licensee must be able to thoroughly understand all the structural features of a Sukuk that can materially impact the performance of its exposures			

to the transaction. Such exposures may include credit enhancements, liquidity enhancements, triggers, and deal-specific default definitions.			
CA-8.3.2 **Where Sukuk are externally rated, <u>Islamic bank licensees</u> must apply the relevant risk weight given in Paragraph CA-8.4.3 based on the ECAI ratings from recognised agencies listed in Section CA-4.6. Where there are no acceptable ECAI ratings, the RWs will be 1,250% (as shown on table CA-8.4.3) or determined on the basis of the underlying assets as shown in the remainder of this Section for the different types of Sukuk (which may involve market risk as well as credit risk).**	**An Islamic Institution** noted that in this paragraph, the reference to RWs of 1250% is made for unacceptable ECAI ratings or for unrated Sukuk. The RWs of 1250% is applicable only when the Islamic bank retained the securitisation exposure through credit enhancement structure as indicated in CA-8.4.3, however, in this case (CA-8.3), guidance and clarity should be given, what if the Islamic bank holds either ECAI rated Sukuk or unrated Sukuk for investment purposes, and what should be risk weight implications for the Islamic bank? Can Islamic bank substitute the RWs of the originator with the unrated Sukuk? Therefore in this paragraph the reference to RWs of 1250% can be deleted as it appears accurately in CA-8.4.3. The guidance in this paragraph should only focus on the minimum capital requirements to cover the credit risk and market risk arising from the holding of a *Sukūk* in the "banking book" by an Islamic bank, rather than Islamic banks retaining the securitisation exposure through credit enhancement structure. Please refer to paragraphs 493-494 of IFSB-15. In addition to above clarity, the paragraph does not explain if there will be exemptions for unrated Sukuk issued by Governments and Government Related Entities (GRE) and Public Sector Entities (PSE) in the GCC. Therefore, we recommend that the CBB should consider exemptions for unrated Sukuk (held by the Islamic banks for investments in their banking book) issued by Governments and GREs/PSEs in the GCC.	AC-1	RW of 1250% applies. There is a cross-reference to CA-8.4.3 to be helpful. This paragraph is consistent with 493 & 494 of IFSB-15. See CA-4.2.1, it is zero. Not applicable for securitisations. 0% applies for direct claims on GCC governments.
CA-9.1.2 **Owing to the risks outlined in Paragraph CA-9.1.1, real estate**	**An Islamic Institution** noted that the CBB may consider giving guidance in limiting the risks to which the Islamic bank or its PSIAs are exposed through exposures in the sector or applying specific risk	AD-1	Real estate is outlined in CA-9.

investment activities are suitable for an Islamic bank licensee only on a very limited scale and under restrictive conditions designed to control the various risks posed to the Islamic bank licensee and its UPSIAs. Islamic bank licensees must demarcate clearly their real estate exposures into financing and investment categories. The CBB requires licensees to report real estate exposures to the CBB.	weights for this investment. The CBB may provide clarification on the usage and implication of restricted PSIAs for real estate. It is proposed to introduce the following: in the case of restricted investment accounts which are clearly for the purpose of real estate investment, there is no proposed limit on the percentage of such funds that may be invested in real estate. However, supervisory authorities may apply a limit to single exposures at their discretion.		
CA-9.1.5 **From a capital adequacy perspective, where an Islamic bank licensee has a subsidiary through which it carries out real estate investment, its investments in the capital of such a subsidiary must be treated in the same way as an investment in a non-banking commercial entity – that is, by application of a 1250% RW for the investment if this amount is greater than 15% of its regulatory capital. This RW will be applicable on the portion of the investment that exceeds the 15% threshold. The investment in real estate entities below the 15% level will be risk-weighted not lower than in Paragraph CA-**	**An Islamic Institution** suggested that flexibility should be added to the bank in the form of allowing the deduction from the capital, thus, it should be either a deduction from Islamic bank's capital or a risk weighting of 1250%. In this respect, the CBB may provide guidance on the deduction whether it should be taken from Tier 1 (i.e. CET1 or AT1) and/or Tier 2.	AE-1	See comment P-1 above.

9.1.16.			
CA-9.1.6 **If an Islamic bank licensee accepts real estate as collateral, whether residential or commercial, from customers against its financing activities, the eligibility of such real estate as a credit risk mitigant will be subject to the provisions of Section CA-4.7 and subject to the risk-weighting of the concerned contract (see CA-3 for differing contract types). Moreover, an Islamic bank licensee is required to take the following steps when the collateral is in the form of real estate:** **(e) The real estate must be insured under a Takaful scheme against damage and deterioration;**	**A bank** would like to clarify whether land as collateral will also be covered here.	AF-1	This is covered by CA-4.7 as indicated.