DOMESTIC SYSTEMICALLY IMPORTANT BANKS MODULE

DS-A.1 Purpose

Executive Summary

DS-A.1.1 The Domestic Systemically Important Banks (D-SIBs) Module sets out the Central Bank of Bahrain's ('CBB's) framework applicable to Bahraini Islamic banks identified as D-SIBs. This module provides guidance on the CBB's assessment methodology for identifying D-SIBs, and the Higher Loss Absorbency ('HLA') capital requirements to which such banks will be subject. The Module also sets out the supervisory measures and requirements to be applied by banks identified as being systemically important. This requirement is supported by Article 44(c) of the Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law') (Decree No. 64 of 2006).

DS-A.1.2 This Module must be read in conjunction with other parts of the Rulebook, mainly:
(a) Principles of Business;
(b) High-level Controls;
(c) Capital Adequacy;
(d) Stress Testing; and
(e) Internal Capital Adequacy Assessment Process ('ICAAP').

Legal Basis

DS-A.1.3 **This Module contains the CBB's Directive relating to D-SIBs and is issued under the powers available to the CBB under Article 38 of the CBB Law. The Directive in this Module is applicable to all Islamic bank licensees.**

DS-A.1.4 For an explanation of the CBB's rule-making powers and different regulatory instruments, see Section UG-1.1.

DS-A.2 Module History

Evolution of the Module

DS-A.2.1 This Module was first issued in April 2018 as part of Volume Two of the CBB Rulebook. All directives in this Module have been effective since this date. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made. Chapter UG-3 provides further details on Rulebook maintenance and version control.

DS-A.2.1 The most recent changes made to this Module are detailed in the table below:

Summary of Changes

Module Ref.	Change Date	Description of Changes

DS-1.1 Overview

DS-1.1.1 The objective of the D-SIBs framework is to identify banks that could cause significant disruption to the domestic financial system and economic activity locally in the event of distress or failure. To address the negative externalities posed by such banks, regulatory and supervisory measures will be undertaken with the aim of:

(a) Reducing the probability of failure of D-SIBs, by increasing their going-concern loss absorbency through additional capital requirements, requiring early recovery planning and increasing the intensity of their supervision; and
(b) Reducing the extent or impact of any failure, by improving the resolvability of these banks.

DS-1.2 General Requirements

DS-1.2.1 **Banks designated as D-SIBs must hold designated HLA expressed as Common Equity Tier 1 ('CET1') capital at 2.5 percent of the total Risk-Weighted Assets ('RWA'), as calculated for the purposes of capital adequacy.**

DS-1.2.2 **The HLA requirement must be fully met by the CET1 capital. This is to ensure that the capital held for HLA purposes must be available to absorb losses on a going-concern basis and, as such, enhance the resilience of the relevant D-SIB.**

DS-1.2.3 **Banks designated as D-SIBs will be subject to an annual inspection by the CBB and two prudential meetings per year.**

DS-1.2.4 The HLA requirement and the Pillar 2 capital add-on address the external and internal risks associated with banks from different, but complementary perspectives.

Disclosure Requirement for D-SIBs

DS-1.2.5 **Bahraini banks designated as D-SIBs must disclose their specific D-SIB HLA requirement in their capital disclosures for the purpose of disclosures of the composition of the bank's capital base.**

Recovery and Resolution Plans

DS-1.2.6 **Banks designated as D-SIBs must develop and maintain Recovery and Resolution Plans (RRPs) specific to their circumstances and reflect the nature, complexity, interconnectedness, level of substitutability and size of the bank in question. The RRPs must be approved by the CBB.**

DS-1.3 D-SIBs Assessment Framework

DS-1.3.1 The D-SIBs Assessment Framework aims to assess the degree to which banks are systemically important to the local financial system and domestic economy. Accordingly, the assessment focuses on the impact of a bank's failure within the financial system.

DS-1.3.2 D-SIBs are identified using a two-step approach. The first step is to draw up a preliminary indicative list of D-SIBs based on the quantitative scores calculated using a set of factors/indicators. The second step involves the exercise of supervisory judgment that may serve as a complement to the quantitative assessment process, i.e. to refine the preliminary indicative list by either (i) removing banks from the list; or (ii) including other banks onto the list.

DS-1.3.3 The D-SIBs assessment is based on the following four factors:

(a) Size

1. Size is a key measure of systemic importance. The larger the bank, the more widespread the effect of a sudden withdrawal of its services and, therefore, the greater the chance that its distress or failure would cause disruption to the financial markets and systems in which it operates, and to the broader functioning of the economy. The size factor broadly measures the volume of a D-SIB's banking activities within the local banking system and economy and, therefore, provides a good measure of the potential systemic impact in case a bank should fail.
2. The quantitative indicator used in the D-SIBs framework to measure a bank's size is its total assets, as disclosed in the balance sheet.

(b) Interconnectedness

1. This measure captures the extent of a bank's interconnections with other financial institutions, which could give rise to externalities affecting the financial system and domestic economy.
2. The quantitative indicators used to capture interconnectedness are interbank activities (represented by intra-financial system assets, and intra-financial system liabilities) and securities outstanding.
3. Intra-financial system assets comprise lending to financial institutions (including undrawn committed lines), holding of securities issued by other financial institutions, gross positive current exposure of Securities Financing Transactions and exposure value of those Shari'a compliant Over the Counter ('OTC') derivatives which have positive current market value. Intra-financial system liabilities comprise deposits by other financial institutions (including undrawn committed lines), gross negative current exposure of Securities Financing Transactions and exposure value of those Shari'a compliant OTC derivatives which have negative current market value. The total marketable securities issued by the bank comprise Shari'a compliant fixed income securities and equity issued by the bank. The total marketable securities issued by the bank with the data on maturity structure of these securities will give an indication of the reliance of the bank on wholesale funding markets.

DS-1.3 D-SIB Assessment Framework (Continued)

(c) Substitutability

1. The concept underlying substitutability as a factor for assessing systemic importance is the recognition that the greater the role of a bank in a particular business line, or in acting as a service provider in relation to market infrastructure, the more difficult it will be to swiftly replace that bank and the extent of the products and services it offers, and, therefore, the more significant the risk of disruption in the event that the bank becomes distressed.
2. The quantitative indicators used to capture substitutability are assets under custody (i.e. the value of assets that a bank holds as a custodian), payment activity (i.e. the value of a bank's payments sent through all of the main payments systems of which it is a member) and values of underwritten transactions in Shari'a compliant fixed income and equity markets (i.e. the annual value of Shari'a compliant fixed income and equity instruments underwritten by the bank). This is based on the logic that the higher the market share of a bank, the more difficult it will be to substitute the extent and level of service it provides.

(d) Complexity

1. The degree of complexity of a bank is generally expected to be proportionately related to the systemic impact of the bank's distress, as the less complex a bank is, the more 'resolvable' it will likely be, and, in turn, the more likely the impact of its failure could be contained.
2. The quantitative indicators used to capture complexity are the notional value of Shari'a compliant OTC derivatives (i.e. the ratio of the notional amount outstanding for the bank), Level 3 assets and ratio of the total value of the bank's holding of securities for trading and available for sale category.

Qualitative Indicators

DS-1.3.4 The CBB will apply a supervisory judgmental overlay to the quantitative assessment process recognising that some of the most effective indicators for assessing systemic importance tend not to be of a quantitative nature and, as such, not captured by a quantitative indicator-based measurement approach.

DS-1.3.5 The CBB's indicative list of qualitative indicators that will typically be considered are:

(a) Anticipated business expansion/contraction;
(b) Anticipated mergers and acquisitions;
(c) Analysis of exposures to a particular banking group;
(d) Settlement institution for any payment or clearing system;
(e) Extent of retail banking network;
(f) Number of local and overseas branches;
(g) Extent of non-banking business exposure and income;
(h) Amount and number of non-plain vanilla products/portfolios held;
(i) Amount of off-balance sheet exposures;
(j) Complexity of the group structure; and
(k) Reputational risk.

DS-1.3 D-SIB Assessment Framework (Continued)

Assessment Approach

DS-1.3.6 A weight is assigned to each of the 'size', 'interconnectedness', 'substitutability' and 'complexity' factors. The CBB applies 25 percent equally to all factors towards the final aggregate score.

Category (and weighting)	Individual indicator	Indicator weighting
Size	Total assets	25%
Interconnectedness	Intra-financial system assets	8.33%
	Intra-financial system liabilities	8.33%
	Securities outstanding	8.33%
Substitutability	Assets under custody	8.33%
	Payments activity	8.33%
	Underwritten transactions in Shari'a compliant fixed income and equity markets	8.33%
Complexity	Shari'a compliant OTC derivatives notional value	8.33%
	Level 3 assets	8.33%
	Trading and available-for-sale securities	8.33%

DS-2.1 Recovery and Resolution Plans

DS-2.1.1 Recovery and Resolution Plans (RRPs) developed by DSIBs should be specific to their circumstances reflecting the nature, complexity, interconnectedness, level of substitutability and size of the bank in question. RRPs must include:

(a) High-level substantive summary of the key recovery and resolution strategies and an operational plan for implementation;
(b) Strategic analysis that underlies the recovery and resolution strategies;
(c) Conditions for intervention, describing necessary and sufficient prerequisites for triggering the implementation of recovery or resolution actions;
(d) Concrete and practical options for recovery and resolution measures;
(e) Preparatory actions to ensure that the measures can be implemented effectively and in a timely manner;
(f) Details of any potential material impediments (Shari'a, legal, strategic or technical) to an effective and timely execution of the plans; and
(g) Responsibilities for executing preparatory actions, triggering the implementation of the plans and the actual measures.

DS-2.1.2 The Bank's Board must ensure that RRPs are reviewed on annual basis, or when there are material changes to the bank's structure or operations, its strategy or aggregated risk exposure. Any changes to the RRPs must be approved by the CBB prior to adoption.

DS-2.1.3 Underlying assumptions of the RRPs and stress scenarios must be sufficiently severe, but plausible. Both "solo" specific and "consolidated" stress scenarios, as appropriate, must be considered taking into account the potential impact of cross-border contagion in crisis scenarios, as well as simultaneous stress situations in several significant markets. RRPs must not make the assumption that the CBB or government support can be relied upon to recover the bank.

DS-2.1 Recovery and Resolution Plans (Continued)

DS-2.1.4 **Banks must develop a robust governance structure and sufficient resources to support the recovery and resolution planning process. This includes clear responsibilities of business units, senior management up to, and including, board members. A senior level executive must be made responsible for the overall RRPs. This person must be responsible for ensuring the bank is, and remains, in compliance with the requirements of the RRPs and for ensuring that recovery and resolution planning is integrated into the bank's overall governance processes.**

DS-2.1.5 **Banks must have systems in place that are able to generate, on a timely basis, the information required to support the recovery and resolution planning process to enable both the bank and the CBB to carry out recovery and resolution planning effectively, and, where necessary, implement the RRPs.**

DS-2.1.6 **Banks must engage in periodic simulation and scenario exercises to assess whether the RRPs are feasible and credible. Banks must report to the CBB on an annual basis, before 30th April, the results of the exercise and changes required to the RRPs, if any.**

DS-2.1.7 RRPs should serve as guidance to banks and the CBB in a recovery or resolution scenario. The CBB may implement a different strategy should the bank need to be resolved.

Recovery Plan

DS-2.1.8 **The Recovery Plan must identify possible recovery measures, recovery options and the necessary steps and time needed to implement such measures, as well as assess the associated risks. An effective Recovery Plan must at least consider the following:**

(a) Governance arrangements and escalation process following a trigger event;

(b) Recovery triggers must be well-defined and tailored to the full range of risks faced by the bank. The threshold level for triggers must be calibrated with impact on the bank's economic capital and set out clearly in the bank's recovery plan;

(c) Actions or responses that should occur when triggers are breached; there should be an expectation that breach of a trigger causes a predetermined escalation and information process up to Board and Senior Management level;

DS-2.1 Recovery and Resolution Plans (Continued)

(d) A detailed explanation and analysis, illustrating how the triggers were calibrated, as well as highlighting the effectiveness of the triggers;
(e) Incorporating qualitative triggers in their consideration of whether a recovery response is necessary and, if so, what kind of response would be appropriate;
(f) Incorporating the triggers for recovery planning into the bank's overall risk management framework. Recovery triggers must be aligned with (but not limited to) existing triggers for liquidity or capital contingency plans, early warning indicators and the bank's risk appetite;
(g) Triggers for recovery planning must be complemented by early warning indicators that alert the bank to emerging signs of stress, but that do not yet give rise to a triggering event;
(h) Use at least one market-wide (systemic) stress scenario and one bank-specific (idiosyncratic) stress scenario, as well as a combination of systemic and idiosyncratic stress scenarios to assess the robustness of their Recovery Plans and to assess which recovery options would be effective in a range of stress situations; and
(i) Allocation of losses to shareholders and unsecured and uninsured creditors in a manner that respects the hierarchy of claims.

DS-2.1. 9

Banks must notify the CBB when high levels of stress are experienced and/or recovery plan triggers are breached. Banks must also notify the CBB on the Recovery Plan actions or responses that would be taken by the Bank when the plan is activated.

DS-2.1.10

Banks must use quantitative and, if relevant, qualitative triggers in their recovery plans. The quantitative triggers focused on firm-specific liquidity and capital measures are critical. The quantitative triggers may include different elements such as:
(a) withdrawal of deposits and other funding;
(b) revenue performance (or components of these);
(c) ratings downgrades;
(d) credit risk limits;
(e) equity ratios;
(f) renewal of wholesale financing;
(g) increased collateral requirements;
(h) market rate of return environment; and
(i) senior debt spreads.

DS-2.1.11 **Banks must use two to four stress scenarios, both systemic and idiosyncratic, for the purpose of recovery planning.**

DS-2.1.12 The following elements are illustrative in nature for stress scenarios to be considered in Recovery planning:

a) significant deposit withdrawal or runoff;
b) collapse of global financial markets;
c) significant capital and liquidity impacts;
d) severe losses through a rogue trader;
e) rating downgrades;
f) US Dollar or a Euro crisis;
g) GDP growth rates;
h) loss of goodwill;
i) exodus of talent;
j) currency or commodity prices volatility;
k) increased collateral requirements;
l) bank failures;
m) fraud; and
n) reputational; crisis.

DS-2.1.13 **Banks must consider a variety of feasible recovery options that could play a critical role towards improving resilience and viability ultimately. Such options may include for instance the following illustrative options:**

(a) Issuance of capital instruments at short notice;
(b) Seeking additional liquidity from existing or new sources;
(c) Sale or disposal of a part of the business and assets;
(d) Restricting new business activities;
(e) Lowering dividend pay outs; and
(f) Restructuring.

DS-2.1 Recovery and Resolution Plans (Continued)

Resolution Plan

DS-2.1.14

Banks must establish Resolution Plan intended to facilitate smooth resolution making it feasible without severe market disruption. It must include a substantive resolution strategy approved by the Board and agreed with the CBB, and an operational plan for its implementation. It must identify, in particular:

(a) Financial and economic functions for which continuity during the resolution process is critical;
(b) Suitable resolution options to preserve those functions, or wind them down in an orderly manner;
(c) Data requirements on the bank's business operations, structures and systemically important functions;
(d) Potential legal, Shari'a, strategic or technical barriers to effective resolution and actions to mitigate those barriers; and
(e) Actions to protect insured depositors and ensure the rapid return of segregated client assets.

DS-2.1.15

Banks must consider the following important elements in their analysis leading to the development of the resolution plan:

(a) The corporate and group structure
(b) Relevant entities and the identification of material entities;
(c) Balance sheet profile including on and off balance sheet;
(d) Funding, liquidity and capital needs;
(e) Business model of the parent and material entities;
(f) Core business lines;
(g) Operational, financial, legal, Shari'a and structural dependencies;
(h) External dependencies;
(i) Financial functions mapping each material entity and business lines;
(j) Resolution strategies and options.

DS-2.1.16

Banks must ensure that key Service Level Agreements (SLAs) can be maintained in crisis situations and in resolution, and that the underlying contracts include provisions that prevent termination triggered by recovery or resolution events, and facilitate transfer of the contract to a bridge institution or a third party acquirer.

DS-2.1.17

Nothing in this Module will preclude CBB from devising other resolution strategies, options or plans recognised under the CBB Law should it believe it is necessary under the circumstances.

DS-3.1 Independent Review

DS-3.1.1

Banks must ensure that the recovery and resolution planning framework is subject to independent review by the internal auditor, on an annual basis, and a third party consultant, other than the external auditor, every 3 years as required under HC-6.6.

DS-3.1.2

In addition to the requirements under HC-6.6, such reviews must test compliance by banks with the requirements of this Module and ensure the coverage includes the following:

(a) Assessment of systemic importance of the bank as per the requirements of this Module;

(b) Adequacy of management oversight and approval of the RRPs;

(c) Adequacy of documentation supporting the RRPs;

(d) Integration of ICAAP and stress testing into RRP process;

(e) Sufficiency of the trigger framework and the process for implementing and monitoring them;

(f) Escalation process and the integrity of the planned actions against the triggers;

(g) Authorisation for, and implementation of, significant changes to the RRPs;

(h) Alignment of the RRPs to the bank's business strategies, group and organisational structure;

(i) Due consideration of the legal and external environment;

(j) Verification of the quality of data sources used to run the stress tests (e.g. in terms of accuracy, consistency, timeliness, completeness and reliability).