CREDIT RISK MANAGEMENT MODULE

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CM-2.1 Overview

CM-2.1.1 The CBB's directives on large exposures for licensees in Bahrain are issued as part of the CBB's measures to encourage licensees to mitigate risk concentrations and to design the licensees' large exposure framework so that the maximum possible loss the licensee could incur, if a single counterparty or group of connected counterparties were to suddenly fail, would not endanger the licensee's survival as a going concern.

CM-2.1.2 The contents of this Chapter apply in full to all Bahraini conventional bank licensees on a consolidated basis.

CM-2.1.3 The application of the large exposures framework at the consolidated level implies that the licensee must consider all exposures to third parties across the relevant regulatory consolidation group and compare the aggregate of those exposures with the group's consolidated Tier 1 capital.

CM-2.1.4 The CBB may, if circumstances so require and on a case-by-case basis, apply the full or part of the requirements of this Chapter to branches of foreign bank licensees.

CM-2.1.5 Licensees must consider exposures to all counterparties unless specifically exempted under this Chapter.

CM-2.1.6 For the purposes of measuring exposures, the counterparty will generally be the person from whom the concerned funds are receivable (in the case of fees and commissions etc.), the borrower (customer) in the case of credit facilities; the person guaranteed; the issuer of a security in the case of a security held; or the party with whom a contract was made in the case of a derivative contract.

CM-2.1.7 The CBB requires each Bahraini conventional bank licensee to set out its policy and internal limits on large exposures, including limits for differing types of exposures, to individual customers, banks, corporates, countries, regions, products, asset classes, collateral, currencies, markets, commodities, connected counterparties and economic sectors, in a policy statement which must be formally approved by the Board of Directors.

CM-2.1.8 Bahraini conventional bank licensees are required to implement appropriate internal systems and controls to monitor large exposures.

CM-2.2 Measure of Exposure

CM-2.2.1 The exposure values licensees must consider in order to identify large exposures to a counterparty are all those exposures defined under the risk-based capital framework in Module CA. It must consider both on- and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk.

CM-2.2.2 An exposure amount to a counterparty that is deducted from capital must not be added to other exposures to that counterparty for the purpose of the large exposure limit. However, all other exposures to the same counterparty must be added together (without having regard to the level of risk-weight) for the purpose of large exposure limit, except if this exposure is specifically exempted.

CM-2.2.3 The exposure value must be defined as the accounting value of the exposure net of specific provisions and value adjustments.

CM-2.2.4 The exposure value for instruments that give rise to counterparty credit risk and are not securities financing transactions must be the exposure at default according to the standardised approach for counterparty credit risk (SA-CCR). The exposure value of securities financing transaction (SFT) exposures must be calculated using the comprehensive approach with relevant supervisory haircuts.

CM-2.2.5 For the purpose of the large exposures, off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the standardised approach for credit risk in Section CA-3.3.

CM-2.2.6 Instruments such as swaps, futures, forwards and credit derivatives must be converted into positions following Section CA-3.3. These instruments are decomposed into their individual legs.

CM-2.2 Measure of Exposure

CM-2.2.7 For the purpose of the banking book and the trading book, the measure of exposure, net of specific provisions, reflects the maximum loss that will arise should a counterparty fail, or the loss that may arise due to exposures relating to concentration per product, asset classes, collateral, segments, country, region, currencies, market, etc. In certain cases (particularly derivatives), the measure of an exposure may be larger than that used in published financial statements. Consistent with this, an exposure encompasses the amount at risk arising from the licensee's:

(a) Claims on a counterparty, including actual and potential claims which would arise from the drawing down in full of undrawn advised facilities (whether revocable/irrevocable, conditional or unconditional) which the licensee has committed itself to provide, and claims which the licensee has committed itself to purchase or guarantee/underwrite. In the case of undrawn facilities (including overdrafts), the advised limit must be included in the measure of exposure (after deduction of any provisions). In the case of loans, the net outstanding balance to be repaid, as shown in the books of the licensee, must be included in the measure of exposure after deduction of any provisions. These claims would include, but are not limited to:
    - (i) Loans and other credit facilities (including overdrafts) whether or not drawn;
    - (ii) Exposures arising through lease agreements;
    - (iii) Margin held with exchanges or counterparties;
    - (iv) Claims under derivative contracts such as futures, forwards, options, swaps and similar contracts on interest rates, foreign currencies, equities, securities, commodities or indexes;
    - (v) Claims arising in the course of settlement of securities transactions;
    - (vi) Receivables, such as fees or commissions;
    - (vii) Claims arising in the case of forward sales and purchases of financial instruments in the trading or banking books;
    - (viii) Amounts outstanding under sale and repurchase agreements, forward asset purchase agreements, buyback agreements, stock borrowing/lending or similar transactions;
    - (ix) Bonds, bills or other non-equity financial instruments; and
    - (x) Underwriting exposures for bonds, bills, or other non-equity financial instruments.

CM-2.2 Measure of Exposure (Continued)

(b) Contingent liabilities arising in the normal course of business, and those contingent liabilities which would arise from the drawing-down in full of undrawn advised facilities (whether revocable or irrevocable, conditional or unconditional) which the licensee has committed itself to provide. In the case of an undrawn overdraft, letter of credit ('L/C') or similar facility, the advised limit must be included in the measure of exposure. Such liabilities may include:
- (i) Direct credit substitutes (including guarantees, standby letters of credit, bills accepted but not held by the reporting bank, and endorsements creating payable obligations);
- (ii) Claims sold with recourse (i.e. where the credit risk remains with the reporting bank);
- (iii) Transaction-related contingents not having the character of direct credit substitutes (e.g. performance bonds, bid bonds, transaction-related L/Cs etc.);
- (iv) Undrawn documentary letters of credit issued or confirmed;
- (v) Credit derivatives sold (where the licensee is providing credit protection); and
- (vi) Asset value guarantees (where the licensee provides protection on exit price or realisable value of a non-financial asset).

(c) Any other assets or transactions whose value depends wholly or mainly on a counterparty performing its obligations, or whose value depends upon that counterparty's financial soundness, but which do not represent a claim on the counterparty. Such assets or transactions include:
- (i) Equities and other capital instruments;
- (ii) Equity warrants, options, or equity derivatives where the reporting bank is obtaining credit protection; and
- (iii) Underwriting or purchase commitments for equities.

(d) Investments transactions in trading book (e.g. index positions, securitisations, investments in hedge funds or investment funds) must be calculated by applying the same rules as for similar instruments in the banking book. The amount invested in a particular structure may be assigned to the structure itself, defined as a distinct counterparty to the counterparties corresponding to the underlying assets, or to the unknown client.

CM-2.2.8 **For credit derivatives that represent sold protection, the exposure to the referenced name must be the amount due in cases where the referenced name triggers the instrument, minus the absolute value of the credit protection. For credit-linked notes, the protection seller needs to consider positions both in the bond of the note issuer and in the underlying referenced by the note.**

CM-2.2 Measure of Exposure (Continued)

CM-2.2.9 The measures of exposure values of options for this Chapter differ from the exposure value used for purposes of Chapter CA-4. The exposure value must be based on the change(s) in option prices that would result from a default of the respective underlying instrument. The exposure value for a simple long call option is its market value and for a short put option is the strike price of the option minus its market value. In cases involving short-call or long-put options, a default of the underlying would lead to a profit (i.e. a negative exposure) instead of a loss, resulting in an exposure of the option's market value in the former case and equal the strike price of the option minus its market value in the latter case. The resulting positions will, in all cases, be aggregated with those from other exposures. After aggregation, negative net exposures must be set to zero.

CM-2.2.10 In case of syndicated facilities initially underwritten by the licensee, the nominal amount would include only the licensee's share of the syndication and any amounts for which binding commitments from other financial institutions are not available or have not been sold down. Where a binding commitment is available, that amount would be excluded in calculation of the large exposures.

Eligible Credit Risk Mitigation ('CRM') Techniques

CM-2.2.11 Bahraini conventional bank licensee must recognise an eligible CRM technique in the calculation of an exposure whenever it has used this technique to calculate the risk-based capital requirements under Chapter CA-4. Eligible credit risk mitigation techniques for large exposures are those that meet the minimum requirements and eligibility criteria for the recognition of unfunded credit protection and financial collateral that qualify under Chapter CA-4. Other forms of collaterals, e.g. receivables, commercial and residential real estate are not eligible to reduce exposure values for large exposure purposes.

CM-2.2.12 In accordance with Paragraph CA-4.6.3, hedges with maturity mismatches are recognised only when their original maturities are equal to or greater than 1 year and the residual maturity of a hedge is not less than 3 months.

CM-2.2 Measure of Exposure (Continued)

CM-2.2.13 If there is a maturity mismatch in respect of credit risk mitigants (collateral, on balance sheet netting, guarantees and credit derivatives) recognised under Paragraph CA-4.6.3, the adjustment of the credit protection for the purpose of calculating large exposures must be calculated according to CA-4.6.4.

CM-2.2.14 Where a licensee has in place legally enforceable netting arrangements for loans and deposits, it may calculate the exposure values for large exposures purposes according to the calculation it uses for capital requirements purposes – i.e. on the basis of net credit exposures subject to the conditions set out in the approach to on-balance sheet netting in Section CA-4.4.

CM-2.2.15 Bahraini conventional bank licensee must reduce the value of the exposure to the original counterparty by the amount of eligible CRM technique recognised under Chapter CA-4. The recognised amount is:

(a) The value of the protected portion in the case of unfunded credit protection;
(b) The value of the portion of the claim collateralised by the market value of the recognised financial collateral when the licensee uses the simple approach under Section CA-4.2;
(c) The value of the collateral adjusted after applying the required haircuts, in the case of financial collateral when the licensee applies the comprehensive approach (see Section CA-4.3); and
(d) The value of the collateral as recognised in the calculation of the counterparty credit risk exposure value for any instruments with counterparty credit risk, such as over-the-counter derivatives.

CM-2.2.16 Whenever a licensee is required to recognise a reduction of the exposure to the original counterparty due to an eligible CRM technique, it must also recognise an exposure to the CRM provider. The amount assigned to the CRM provider is the amount by which the exposure to the original counterparty is reduced (except in the case it is a Credit Default Swap ('CDS') as in Paragraph CM-2.2.26).

CM-2.2 Measure of Exposure (Continued)

Calculation of Exposure value for Trading Book Positions

CM-2.2.17 **Bahraini conventional bank licensees must add any exposures to a single counterparty arising in the trading book to any other exposures to that counterparty that lie in the banking book to calculate its total exposure to that counterparty.**

CM-2.2.18 The exposures considered in this section correspond to concentration risk associated with the default of a single counterparty for exposures included in the trading book. Therefore, positions in financial instruments such as bonds and equities must be constrained by the large exposure limit, but concentrations in a particular commodity or currency need not be.

CM-2.2.19 **Exposure values of licensees' investments in transactions (i.e. index positions, securitisations, hedge funds or investment funds) must be calculated applying the same rules as for similar instruments in the banking book. Similarly, covered bonds held in the trading book are subject to the same treatment as the banking book.**

Offsetting Long and Short Positions in the Trading Book

CM-2.2.20 **Bahraini conventional bank licensee's exposure arising from securities' trading operations is calculated as its net long position in a particular security (a short position in one security issue may not be offset against a long position in another issue made by the same issuer). The licensee's 'net long position' in a security refers to its commitment to buy that security together with its current holdings of the same security, less its commitment to sell these securities.**

CM-2.2.21 **Positions in the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical) may only be offset for the purpose of calculating large exposure.**

CM-2.2.22 **Positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.**

CM-2.2.23 **For positions hedged by credit derivatives, the hedge may be recognised provided the underlying of the hedge and the position hedged fulfil the provision of Paragraph CM-2.2.22.**

CM-2.2.24 **When the result of the offsetting is a net short position with a single counterparty, this net exposure need not be considered as an exposure for the purpose of this Chapter.**

CM-2.2 Measure of Exposure (Continued)

CM-2.2.25 In order to determine the relative seniority of positions, securities may be allocated into broad buckets of degrees of seniority (for example, 'equity', 'subordinated debt' and 'senior debt'). For licensees that find it excessively burdensome to allocate securities to different buckets based on relative seniority, they may recognise no offsetting of long and short positions in different issues relating to the same counterparty in calculating exposures.

CM-2.2.26 When the credit protection takes the form of a Credit Default Swap ('CDS') and either the CDS provider or the referenced entity is not a financial entity, the amount to be assigned to the credit protection provider is not the amount by which the exposure to the original counterparty is reduced but, instead, the counterparty credit risk exposure calculated in accordance with Module CA.

CM-2.2.27 Netting across the banking and the trading books is not permitted.

Covered Bonds

CM-2.2.28 Covered bonds are bonds issued by a bank or mortgage institutions and are subject by law to special public supervision designed to protect bond-holders. Proceeds deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of the validity of the bonds, are capable of covering claims attached to the bonds and which, in the event of the failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

CM-2.2.29 A covered bond satisfying the conditions set out in Paragraph CM-2.2.30, may be assigned an exposure value of no less than 20% of the nominal value of the licensee's covered bond holding. Other covered bonds must be assigned an exposure equal to 100% of the nominal value of the licensee's covered bond holding. The counterparty to which the exposure value is assigned is the issuing bank.

CM-2.2 Measure of Exposure (Continued)

CM-2.2.30 To be eligible to be assigned an exposure value of less than 100%, a covered bond must satisfy all the following conditions:

(a) It must meet the general definition set out in CM-2.2.28.

(b) The pool of underlying assets must exclusively consist of one or more of the following:

(i) Claims on, or guaranteed by, sovereigns, their central banks, public sector entities or multilateral development banks;

(ii) Claims secured by mortgages on residential real estate that would qualify for a 35% or lower risk-weight under Section CA-3.2 and have a loan-to-value ratio of 80% or lower;

(iii) Claims secured by commercial real estate that would qualify for the 100% or lower risk-weight under Section CA-3.2 and with a loan-to-value ratio of 60% or lower; and/or

(iv) Claims on or guaranteed by banks that qualify for a 30% or lower risk weight. However, such assets cannot exceed 15% of covered bond issuances; and

(c) The nominal value of the pool of assets assigned to the covered bond instrument(s) by its issuer must exceed its nominal outstanding value by at least 10%. The value of the pool of assets for this purpose does not need to be that outlined by the legislative framework. However, if the legislative framework does not stipulate a requirement of at least 10%, the issuing bank needs to publicly disclose on a regular basis that their cover pool meets the 10% requirement in practice. In addition to the primary assets listed under this Sub-paragraph, the additional collateral may include substitution assets (cash or short-term liquid and secure assets held in substitution of the primary assets to top up the cover pool for management purposes) and derivatives entered into for the purposes of hedging the risks arising in the covered bond program.

CM-2.2.31 In order to calculate the required maximum loan-to-value for residential real estate and commercial real estate referred to in Paragraph CM-2.2.30, the following requirements must be met:

(a) Legal Enforceability: Any claim on a collateral taken must be legally enforceable in all relevant jurisdictions, and any claim on collateral must be properly filed on a timely basis. Collateral interests must reflect a perfected lien (i.e. all legal requirements for establishing the claim have been fulfilled). In addition to this, the collateral agreement and the legal process underpinning it must be such that they allow the licensee to realise the value of the collateral within a reasonable timeframe;

CM-2.2 Measure of Exposure (Continued)

(b) Objective market value of collateral: the collateral must be valued at or less than the current fair value under which the property could be sold under private contract between a willing seller and an arm's-length buyer on the date of valuation; and

(c) Frequent Revaluation: The licensee must monitor the value of the collateral on a frequent basis and, at a minimum, once a year. More frequent monitoring is suggested where the market is subject to significant changes in conditions. Statistical methods of evaluation (e.g. reference to house price indices, sampling) may be used to update estimates or to identify collateral that may have declined in value and that may need reappraisal. A qualified professional must evaluate the property when information indicates that the value of the collateral may have declined materially relative to general market prices, or when a credit event, such as a default, occurs.

CM-2.2.32 The conditions set out in Paragraph CM-2.2.30 must be satisfied at the inception of the covered bond and throughout its remaining maturity.

Collective Investment Undertakings, Securitisation Vehicles and Other Structures

CM-2.2.33 Bahraini conventional bank licensees must consider exposures even when a structure lies between the licensee and the exposures, that is, even when the licensee invests in structures through an entity which itself has exposures to assets ('underlying assets'). Bahraini conventional bank licensees must assign the exposure amount, i.e. the amount invested in a particular structure, to specific counterparties following the approach described in Paragraphs CM-2.2.34 to CM-2.2.41. The structures include funds, securitisations and other structures with underlying assets.

CM-2.2.34 Bahraini conventional bank licensee may assign the exposure amount to the structure itself, defined as a distinct counterparty, if it can demonstrate that the licensee's exposure amount to each underlying asset of the structure is smaller than 0.25% of its Tier 1 capital, considering only those exposures to underlying assets that result from the investment in the structure itself, and using the exposure value calculated according to Paragraphs CM-2.3.34 and CM-2.3.35. By definition, this required test will be passed if the bank's whole investment in a structure is below 0.25% of its Tier 1 capital. In this case, the licensee is not required to look through the structure to identify the underlying assets.

CM-2.2 Measure of Exposure (Continued)

CM-2.2.35 Bahraini conventional bank licensees must look through the structure to identify those underlying assets for which the underlying exposure value is equal to or above 0.25% of its Tier 1 capital. In this case, the counterparty corresponding to each of the underlying assets must be identified so that these underlying exposures can be added to any other direct or indirect exposure to the same counterparty. The licensee's exposure amount to the underlying assets that are below 0.25% of its Tier 1 capital may be assigned to the structure itself (i.e. partial Look-Through-Approach ('LTA') is permitted).

CM-2.2.36 If a Bahraini conventional bank licensee is unable to identify the underlying assets of a structure:

(a) where the total amount of its exposure does not exceed 0.25% of its Tier 1 capital, the licensee must assign the total exposure amount of its investment to the structure; otherwise

(b) Assign this total exposure amount to the unknown client.

CM-2.2.37 Bahraini conventional bank licensees must aggregate all 'unknown exposures' as if they are related to a single counterparty (the unknown client), to which the large exposure limit would apply.

CM-2.2.38 When a LTA is not required, according to Paragraph CM-2.2.34, a Bahraini conventional bank licensee must, nevertheless, be able to demonstrate that regulatory arbitrage considerations have not influenced the decision whether to look through or not – e.g. that the licensee has not circumvented the large exposure limit by investing in several individually immaterial transactions with identical underlying assets.

CM-2.2.39 If the LTA need not be applied, Bahraini conventional bank licensee's exposure to the structure must be the nominal amount it invests in the structure.

CM-2.2.40 When the LTA is required, the exposure value assigned to a counterparty is equal to the pro rata share that the licensee holds in the structure multiplied by the value of the underlying asset in the structure. Thus, the licensee holding a 1 percent share of a structure that invests in 20 assets each with a value of 5, must assign an exposure of 0.05 to each of the counterparties. An exposure to a counterparty must be added to any other direct or indirect exposures the licensee has to that counterparty.

CM-2.2 Measure of Exposure (Continued)

CM-2.2.41 **When the LTA is required, the exposure value to a counterparty is measured for each tranche within the structure, assuming a pro rata distribution of losses amongst investors in a single tranche. To compute the exposure value to the underlying asset, the licensee must:**

(a) Consider the lower of the value of the tranche in which the licensee invests and the nominal value of each underlying asset included in the underlying portfolio of assets; and

(b) Apply the pro rata share of the licensee's investment in the tranche to the value determined in the first step above.

Identification of Additional Risks

CM-2.2.42 **Bahraini conventional bank licensees must identify third parties that may constitute an additional risk factor inherent in a structure itself rather than in the underlying assets. This third party could be a risk factor for more than one structure that the licensee invests in. Examples of roles played by third parties include originator, fund manager, liquidity provider and credit protection provider.**

CM-2.2.43 Bahraini conventional bank licensees should connect their investments in those structures with a common risk factor, to form a group of connected counterparties. In such cases, the manager would be regarded as a distinct counterparty so that the sum of the licensee's investments in all of the funds managed by this manager would be subject to the large exposure limit, with the exposure value being the total value of the different investments. In other cases, the identity of the manager may not comprise of an additional risk factor – for example, if the legal framework governing the regulation of particular funds requires separation between the legal entity that manages the fund, and the legal entity that has custody of the fund's assets.

CM-2.2.44 In the case of structured finance products, the liquidity provider or sponsor of short-term programmes (asset-backed commercial paper – 'ABCP' conduits and structured investment vehicles – 'SIVs') may warrant consideration as an additional risk factor (with the exposure value being the amount invested). Similarly, in synthetic deals, the protection providers (sellers of protection by means of CDS/guarantees) may be an additional source of risk and a common factor for interconnecting different structures (in this case, the exposure value would correspond to the percentage value of the underlying portfolio).

CM-2.2 Measure of Exposure (Continued)

CM-2.2.45 Bahraini conventional bank licensees may add their investments in a set of structures associated with a third party that constitutes a common risk factor to other exposures (such as a loan) it has to that third party. Whether the exposures to such structures must be added to any other exposures to the third party, would again depend on a case-by-case consideration of the specific features of the structure and on the role of the third party. In the example of the fund manager, adding together the exposures may not be necessary because potentially fraudulent behaviour may not necessarily affect the repayment of a loan. The assessment may be different where the risk to the value of investments underlying the structures arises in the event of a third-party default. For example, in the case of a credit protection provider, the source of the additional risk for the bank investing in a structure is the default of the credit protection provider. The licensee must add the investment in the structure to the direct exposures to the credit protection provider since both exposures might crystallise into losses in the event that the protection provider defaults (ignoring the covered part of the exposures may lead to the undesirable situation of a high concentration risk exposure to issuers of collateral or providers of credit protection).

CM-2.2.46 It is conceivable that the licensee may consider multiple third parties to be potential drivers of additional risk. In this case, the licensee should assign the exposure resulting from the investment in the relevant structures to each of the third parties.

CM-2.2.47 The requirement set out in Paragraph CM-2.2.42 to recognise a structural risk inherent in the structure instead of the risk stemming from the underlying exposures is independent of whatever the general assessment of additional risks concludes.

Exposures to Central Counterparties

CM-2.2.48 Exposures to qualified central counterparties ('QCCPs') related to clearing activities are exempted from the requirements of this Chapter.

CM-2.2.49 The definition of QCCP for large exposures purposes is the same as that used for risk-based capital requirement purposes. A QCCP is an entity that is licensed to operate as a central counterparty (CCP) (including a license granted by way of confirming an exemption) and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the Committee on Payment and Financial Infrastructure and International Organization of Securities Commissions' Principles for Financial Market Infrastructures.

CM-2.2 Measure of Exposure (Continued)

CM-2.2.50 In the case of non-QCCPs, Bahraini conventional bank licensees must measure their exposure as a sum of both the clearing exposures described in Paragraph CM-2.2.52 and the non-clearing exposures described in Paragraph CM-2.2.54 and must respect the general large exposure limit of 25% of consolidated Tier 1 Capital.

CM-2.2.51 The concept of connected counterparties referred to in CM-2.3.5 does not apply in the context of exposures to centralised counterparties ('CCPs') that are specifically related to clearing activities.

CM-2.2.52 Bahraini conventional bank licensees must identify exposures to a CCP related to clearing activities and sum together these exposures. Exposures related to clearing activities are listed in the table below, together with the exposure value to be used:

Type of exposure	Exposure value
Trade Exposures	The exposure value of trade exposures must be calculated using the exposure measures prescribed in this Chapter for the respective type of exposures (e.g. using the SA-CCR for derivative exposures).
Segregated Initial Margin	The exposure value is 0.
Non-segregated Initial Margin	The exposure value is the nominal amount of initial margin posted.
Pre-funded Default Fund Contributions	Nominal amount of the funded contribution.
Unfunded Default Fund Contributions	The exposure value is 0.
Equity Stakes	The exposure value is the nominal amount.

CM-2.2.53 Regarding exposures subject to clearing services (the licensee acting as a clearing member or being a client of a clearing member), the licensee must determine the counterparty to which exposures must be assigned by applying the provisions of Module CA.

CM-2.2.54 Other types of exposures that are not directly related to clearing services provided by the CCP, such as funding facilities, credit facilities, guarantees, etc. must be measured according to the rules set out in this Chapter as for any other type of counterparty. These exposures will be added together and be subjected to the large exposure limit.

CM-2.3 Limits for Large Exposures

CM-2.3.1 **A 'large exposure' is any exposure to a counterparty or a group of connected counterparties which is greater than, or equal to, 10 percent of the reporting Bahraini conventional bank licensee's consolidated Tier 1 capital.**

CM-2.3.2 **The sum of all the exposures of a Bahraini conventional bank licensee to a single counterparty or to a group of connected counterparties must not be higher than 25% of the bank's consolidated Tier 1 capital at all times. This limit is set at 15% for a Domestic Systemically Important Bank's (DSIB) exposures to another DSIB. Where the licensee has an exposure to a bank that is later designated to be a DSIB, it must comply with such limit within 12 months of the designation.**

CM-2.3.3 **Breaches of the limit, must be communicated immediately to the CBB and must be rectified within 3 months. Where the licensee does not rectify its status within 3 months, the excess amount must be risk-weighted at 800% and the CBB will at its discretion impose, restrictions and other measures including enforcement actions.**

Connected counterparties

CM-2.3.4 In some cases, a bank may have exposures to a group of counterparties with specific relationships or dependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this Chapter as a group of connected counterparties, must be treated as a single counterparty. In this case, the sum of the bank's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements.

CM-2.3.5 **Bahraini conventional bank licensees must assess the relationship amongst counterparties in order to establish the existence of a group of connected counterparties. Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied:**

(a) Control relationship: One of the counterparties, directly or indirectly, has control over the other(s); or

(b) Economic interdependence: If one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties.

CM-2.3 Limits for Large Exposures (Continued)

CM-2.3.6 **In assessing whether there is a control relationship between counterparties, licensees must automatically consider that criterion CM-2.3.5(a) is satisfied if one entity owns more than 50% of the voting rights of the other entity.**

CM-2.3.7 **Bahraini conventional bank licensees must assess connectedness between counterparties based on control using the following criteria:**

(a) Voting agreements (e.g. control of a majority of voting rights pursuant to an agreement with other shareholders);
(b) Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;
(c) Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g. through consent rights over key decisions).

CM-2.3.8 Bahraini conventional bank licensees are also expected to refer to criteria specified in IFRS for further qualitative guidance when determining control.

CM-2.3.9 For further clarity a person A is controlled by another person B for the purposes of subparagraph CM-2.3.5(a) if A is:

(a) a person in which B holds more than half of the total number of issued shares, whether legally or beneficially;
(b) a person in which B controls more than half of the voting power;
(c) a person in which B controls the composition of the board of directors (i.e. if B has the power, exercisable by B without the consent or concurrence of any other person, to appoint or remove all or a majority of board members);
(d) a subsidiary of a person described in subparagraph (a), (b) or (c); or
(e) a person the policies of which B is in a position to determine;

CM-2.3.10 Where control has been established based on any of the criteria set out in Paragraphs CM-2.3.5(a) and CM-2.3.7, licensees may still demonstrate to the CBB in exceptional cases, e.g. due to the existence of specific circumstances and corporate governance safeguards, that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

CM-2.3 Limits for Large Exposures (Continued)

CM-2.3.11 **In establishing connected counterparty relationships based on economic interdependence (CM-2.3.5 (b)), licensees must consider, at a minimum, the following qualitative criteria:**

(a) Where 50 percent or more of one counterparty's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent);

(b) Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;

(c) Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;

(d) When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;

(e) Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;

(f) Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); and

(g) When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found. In this case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

CM-2.3.12 There may, however, be circumstances where some of these criteria do not automatically imply an economic interdependence that results in two or more counterparties being connected. Provided that the bank can demonstrate to the CBB that a counterparty which is economically connected to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the bank does not need to combine these counterparties to form a group of connected counterparties.

CM-2.3.13 **There are cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, licensees are required to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds 5% of its consolidated Tier 1 capital.**

CM-2.3 Limits for Large Exposures (Continued)

CM-2.3.14 Where two or more entities that are outside the scope of sovereign exemption are controlled by or are economically dependent on an entity that falls within the scope of the sovereign exemption referred to in paragraph CM-2.5.1, and are otherwise not connected with each other based on other control relationship or economic dependence relationship, those entities need not be deemed to constitute a group of connected counterparties pursuant to paragraph CM-2.3.5. Additionally, consistent with Module CA, where other supervisors also treat claims on named PSEs as claims on their sovereigns, claims to those PSEs are treated as claims on the respective sovereigns.

CM-2.4 Exposures to Related Parties

CM-2.4.1 **Exposures to related parties of Bahraini conventional bank licensees must be only undertaken for clear commercial advantage of the licensee and negotiated and agreed on an arm's-length basis i.e. at market value or on terms no more favourable than would be agreed if the transaction was not with a related party. Exposures undertaken must be consistent with business of the licensee i.e. the licensee must not enter into transactions that are outside the scope of its ordinary course of business.**

CM-2.4.2 For the purposes of Paragraph CM-2.4.1, the following are indications of exposures not on an arm's-length basis:
(a) Accepting less security for the performance of obligations than is required from other clients;
(b) Acquiring property of low quality or at an inflated price from a person related to the bank;
(c) Making an investment in securities of a person related to the bank that the bank would not have made with non-related counterparties;
(d) Paying for goods and services provided by a person related to the bank at prices higher than usual;
(e) Selling a property related to the bank to a person at a value lower than the bank would have received from the sale of such property to non-related counterparties;
(f) Approving transactions through a procedure different from the procedure specified by the bank for similar counterparties;
(g) Approving loans or granting guarantees exceeding the internal limit without any sensible economic ground;
(h) Approving a transaction through a less stringent procedure that the procedure specified by the bank for similar counterparties;
(i) Accepting collateral without proper appraisal or accepting less collateral than the bank would have required from an unrelated person; and
(j) Issuing additional credit despite existing loans in arrears or creating a concentration of risk that the bank would not have approved for an unrelated person.

Definition of related parties

CM-2.4.3 **Related parties include the following:**
(a) An entity that is controlled (see Paragraphs CM-2.3.5(a) and CM-2.3.7) by the licensee;
(b) A person (natural or legal) that controls the licensee or owns 10% or more of the licensee;
(c) An entity that is an associate of the licensee;
(d) An entity that is affiliated with the licensee by virtue of being controlled by, or being an associate of, an entity that controls the licensee;

CM-2.4 Exposures to Related Parties (Continued)

(e) A board member or senior manager (in accordance with FP Module) of the licensee;
(f) A board member or senior manager of an entity that falls within (a) to (d);
(g) A close relative (parents, grandparents, spouses, children, grandchildren and siblings) of a person in (b), (e) and (f); and
(h) A corporate entity controlled by a person in (b), (e) and (f).

CM-2.4.4 Bahraini conventional bank licensees are also expected to refer to criteria specified in IFRS for further qualitative guidance when identifying related parties.

CM-2.4.5 **Related party exposures exclude the following:**
(a) Exposures relating to the remuneration of, or staff benefits (including e.g. favourable interest rates on loans) granted to, board members and employees pursuant to a board / board committee approved remuneration policy; and
(b) Exposures between the licensee and other entities within its group that arise from a central risk or liquidity management function or centrally coordinated services.

CM-2.4.6 **Bahraini conventional bank licensees must establish, implement and maintain effective policies and procedures to identify, evaluate and manage risks arising out of exposures to related parties. The policies and procedures must:**
(a) Prevent a related party from taking part in the licensee's decision-making process in relation to any transaction with that related party;
(b) Set a materiality threshold above which exposures with related parties receive prior approval from the licensee's board / board committees;
(c) Ensure that related party exposures do not significantly impact capital adequacy and liquidity position of the licensee;
(d) Ensure that the licensee records and monitors the details and amounts of any related party transactions using an independent internal credit review or internal audit process; and
(e) Consider and include adequate mitigation measures for contagion risks to the licensee that arise from its group structure and related parties, in particular to step-in risk entities.

CM-2.4 Exposures to Related Parties (Continued)

CM-2.4.7 **The licensee must not undertake exposures to its own external auditor. In this context, 'external auditor' refers to the firm/partnership, the partners, the directors and the managers of the audit firm.**

CM-2.5 Exempt Exposures

CM-2.5.1 Certain types of exposure are exempt from the 25% and 15% exposure limits set out in CM-2.3.2. These exemptions fall into the following categories:

(a) Short term interbank exposures, with original maturities of 3 months or less;
(b) Exposures to GCC central governments and their central banks.
(c) Exposures to central governments and central banks of other countries that are denominated in their domestic currencies;
(d) Exposures to central governments and central banks of other countries that are not denominated in their domestic currencies provided the sovereign credit rating is AA- or above (or equivalent);
(e) Exposures to Bahraini public sector entities listed in appendix CA-18;
(f) Exposures to public sector entities of GCC governments that do not operate on a commercial basis, and are eligible for a 0% risk-weight in accordance with Module CA;
(g) Exposures to public sector entities of other countries with a sovereign credit rating of AA- or above (or equivalent), that do not operate on a commercial basis, and are eligible for a 0% risk-weight in accordance with Module CA;
(h) Exposures to / exposures guaranteed by the Islamic Development Bank or any of its subsidiaries and other multilateral development banks, such as IMF, World Bank, Arab Monetary Fund, Asian Development Bank, African Development Bank, European Bank of Reconstruction and Development;
(i) Exposures to QCCPs as stipulated in Paragraph CM-2.2.48; and
(j) Intra-group exposures to banks that are part of a group (parent banks and banks falling under Subparagraphs CM-2.4.5 (a), (c) and (d) where the ultimate parent bank is located in Bahrain), provided all the banks in the group are consolidated at the parent level and the group is subject to consolidated supervision by the CBB.

CM-2.5.2 If a Bahraini conventional bank licensee has an exposure to any entity noted in Paragraph CM-2.5.1 which is hedged by a credit derivative, the licensee will have to recognise an exposure to the counterparty providing the credit protection, as prescribed in Paragraphs CM-2.2.16 and CM-2.2.26, notwithstanding the fact that the original exposure is exempted.

CM-2.6 Reporting of Exposures

CM-2.6.1 Conventional bank licensees are required to report their 25 largest exposures to banks as well as their 25 largest exposures to non-banks to the CBB on a quarterly basis using the Form PIR provided in Appendix BR-5.

CM-2.6.2 Bahraini conventional bank licensees must report the financial details of each large exposure, in Appendix BR-19, as required under Paragraph BR-3.1.10. The report must include the following:

(a) All exposures with values measured equal to or above 10% of the licensee's Tier 1 capital;
(b) All other exposures with values measured without the effect of credit risk mitigation equal to or above 10% of the licensee's Tier 1 capital; and
(c) All the exempted exposures with values equal to or above 10% of the licensee's Tier 1 capital.

CM-2.6.3 Bahraini conventional bank licensees must report all their exposures to related parties on a quarterly basis using the form provided in Appendix BR-11, as required under Paragraph BR-4.3.4.

CM-2.6.4 Bahraini conventional bank licensees must report the calculations of credit concentration risk to the CBB in their ICAAP reports in accordance with Section CM-2.7.

CM-2.7 Credit Concentration Risk

CM-2.7.1 Bahraini conventional bank licensees must calculate credit concentration risk using the Herfindahl-Hirschman Index (HHI) applied on the risk-weighted assets on a single name and sector concentration basis. The following capital add-ons must be applied:

Concentration Risk Bucket	1		2		3		4		5	
Single name concentration risk										
HHI RWA	0%	0.29%	0.29%	0.59%	0.59%	1.15%	1.15%	1.65%	>1.65%	
Capital Add-on (% portfolio RWA)	0%	0.5%	0.5%	1%	1%	2%	2%	3%	3%	4%
Sector concentration risk										
HHI RWA	11.1%	20.3%	20.3%	25.8%	25.8%	41.7%	41.7%	67.4%	>67.4%	
Capital Add-on (% portfolio RWA)	0%	0.25%	0.25%	0.5%	0.5%	1%	1%	1.5%	1.5%	2.8%

CM-2.7.2 For the purposes of Paragraph CM-2.7.1, the sectors for calculating the sector concentration risk are as follows:

(a) Financial activities
(b) Energy industry
(c) Manufacturing
(d) Agriculture, forestry and fishing
(e) Mining and quarrying
(f) Public administration
(g) Construction
(h) Transportation and storage
(i) Real estate activities
(j) Wholesale and retail trade
(k) Information and communication
(l) Professional, scientific and technical activities, and administrative and support service activities
(m) Education
(n) Human health and social work
(o) Accommodation and food services
(p) Other

CM-3.1 Exposures to Board Members and Employees

CM-3.1.1 [This Paragraph was deleted in XX]

CM-3.1.2 [This Paragraph was deleted in XX]

CM-3.1.3 [This Paragraph was deleted in XX]

CM-3.1.4 Bahraini conventional bank licensees must notify the CBB of any write-off of an exposure of an amount of BD 100,000 or more, to a board member or employee of the licensee including exposures to entities owned and controlled (i.e. stake of more than 50%) by them.

CM-4.1 Write-offs [This Chapter was deleted in XX]