



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Single Counterparty Exposure Limit for Islamic Banking Institutions

Issued on: 9 July 2014

BNM/RH/GL 007-22	Islamic Banking and Takaful Department	Single Counterparty Exposure Limit for Islamic Banking Institutions
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PART A OVERVIEW

1. Introduction

1.1. Risk concentration refers to an exposure with the potential to produce losses that are substantial enough to threaten the financial condition of an Islamic banking institution. Risk concentrations can materialise from excessive exposures to a single counterparty and persons connected to it, a particular instrument or a particular market segment. A risk concentration to a single counterparty may arise through direct exposures to the counterparty and indirectly through exposures to guarantors and protection providers. The magnitude of this risk is significantly influenced by the existence of common or correlated risk factors which in times of stress can adversely affect the creditworthiness of each individual counterparty making up the concentration.

Policy Objective

1.2. The single counterparty exposure limit (SCEL) represents a non-risk adjusted back-stop measure to ensure that exposures to a single counterparty and persons connected to it are within a prudent limit at all times.

Scope of Policy

1.3. This policy document sets out-

- (a) the prudential limit for exposures to a single counterparty and persons connected to it;
- (b) the Bank's specification as to what constitutes "connected", "counterparty" and "exposure";
- (c) the Bank's requirements and expectations of Islamic banking institutions in managing and monitoring exposures to a single counterparty and persons connected to it;
- (d) scope and treatment of exposures applicable to a single counterparty and persons connected to it; and
- (e) expectations with respect to on-going compliance with the SCEL.

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2. Applicability

- 2.1. This policy document is applicable to licensed Islamic banks (excluding licensed international Islamic banks), and licensed banks and licensed investment banks approved to carry on Islamic banking business under section 15(1)(a) of the Financial Services Act 2013 (FSA) (collectively referred to as "Islamic banking institutions").
- 2.2. Islamic banking institutions are required to comply with the SCEL at both the entity and consolidated level¹. A licensed bank and licensed investment bank carrying out an Islamic banking business² (IBB), must comply with the requirements in this policy document at the level of the IBB, as if it were a stand-alone Islamic banking institution.

3. Legal provisions

- 3.1. The requirements in this policy document are specified pursuant to sections 57(1) and 59 of the IFSA.

4. Effective date

- 4.1. This policy document comes into effect on 9 July 2014³.

5. Policy document and approvals superseded

- 5.1. With the coming into effect of this policy document, the policy document listed in Appendix 1 is superseded. Where specific approvals have been given by the Bank to Islamic banking institutions in relation to requirements on single

¹ For the definition of entity and consolidated level, refer to *Capital Adequacy Framework for Islamic Banks (Capital Components)*.

² Pursuant to section 15(1) of the FSA, section 14 of the Islamic Financial Services Act 2013 (IFSA) and the *Guidelines on Skim Perbankan Islam*.

³ Transitional arrangements are provided in paragraphs 13.1 to 13.4.

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counterparty exposure limit, such approvals shall no longer be applicable unless otherwise specified by the Bank.

6. Interpretation and Specifications

Interpretation

6.1. The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA and IFSA, as the case may be, unless otherwise defined in this policy document.

6.2. For the purpose of this policy document-

“**S**” denotes a standard, requirement or specification that must be complied with. Failure to comply may result in one or more enforcement actions;

“**G**” denotes guidance which may consist of such information, advice or recommendation intended to promote common understanding and sound industry practices which are encouraged to be adopted;

“**Large exposure**” refers to total exposures to a single counterparty which are equal to or greater than 10% of the Islamic banking institution’s Total Capital;

“**Interbank money market transactions**” refers to ringgit and foreign currency transactions in the money market with a contractual maturity of one year and below which includes secured or unsecured borrowing and lending, and buying and selling of papers with a remaining maturity of one year and below;

“**Related counterparty**” refers to a counterparty which is a related corporation of an Islamic banking institution, and includes related banking entities and non-bank related corporations;

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“Related banking entity” of an Islamic banking institution refers to a related corporation licensed by the Bank or regulated by a foreign regulatory authority to carry on banking business or business which corresponds, or is similar, to banking business, and includes a holding company or subsidiary of a banking institution, subsidiary of a holding company of a banking institution or any other related corporation within the corporate group of a banking institution; and

“Total Capital” has the same meaning assigned to it in the *Capital Adequacy Framework for Islamic Banks (Capital Components)*.

S Specification of “connected”, “counterparty” and “exposure”

6.3. For the purpose of section 59(3) IFSA-

“Connected” is as specified in paragraph 9.2 of this policy document;

“Counterparty” refers to any person with whom an Islamic banking institution has an exposure;

“Exposure” refers to all claims, commitments and contingent liabilities arising from on- and off-balance sheet transactions (in both the banking and trading books) in ringgit and foreign currency denomination (based on their ringgit-equivalent amounts), which include, but are not limited to-

- (a) outstanding loans, financing, advances and receivables;
- (b) placements (include deposit and investment account) and margins held with counterparties;
- (c) debt and equity securities held, including exposures arising from holdings of primary market securities for distribution;
- (d) investments in collective investment schemes;
- (e) exposures arising from derivative contracts; and
- (f) exposures arising from off-balance sheet instruments.

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PART B POLICY REQUIREMENTS

7. Risk Management Requirements

- S** 7.1. The board of directors (Board) of an Islamic banking institution must ensure that-
- (a) the Islamic banking institution establishes and adheres at all times to the internal policies governing risk concentrations, as approved by the Board;
 - (b) the internal policies are reviewed regularly (at least annually) in order to remain current, adequate and appropriate for the Islamic banking institution at all times. Any material changes to the established policies must be approved by the Board; and
 - (c) independent⁴ reviews are conducted regularly to verify compliance to the prudential limit and standards set by the Bank as well as the established internal policies.
- S** 7.2. Senior management of an Islamic banking institution must-
- (a) establish and implement internal policies, processes and procedures governing risk concentrations;
 - (b) clearly communicate and monitor compliance with the internal policies throughout the Islamic banking institution; and
 - (c) establish and maintain adequate systems (either automated or otherwise) that are able to identify, measure, monitor and aggregate exposures to single counterparties in a timely manner.
- S** 7.3. The internal policies governing risk concentration must at a minimum include the following-
- (a) procedures for identifying, measuring, monitoring⁵, controlling and reporting single counterparty exposures of the Islamic banking institution;
 - (b) detailed internal parameters for identifying persons connected to a single counterparty;

⁴ Review shall be carried out by a person who does not undertake risk taking activities.

⁵ Exposures are expected to be monitored on a gross basis, regardless of mitigation allowed.

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- (c) internal exposure limits⁵ (including limits on total large exposures⁶) that are reflective of the Islamic banking institution's risk appetite and risk bearing capacity, which also takes into consideration the potential changes to the market value of the underlying exposures;
- (d) clearly defined roles and accountability for ensuring compliance and effective communication of the policies, procedures and internal limits throughout the Islamic banking institution;
- (e) measures to manage and address compliance with the SCEL, including authority and procedures for approving exceptions to the internal limits which in any case, must not exceed the SCEL; and
- (f) nature and frequency of reporting to the Board and senior management.

- G** 7.4. Although certain types of exposures and counterparties are excluded from the SCEL (as specified in paragraphs 10.1 and 10.2), these exposures are not risk-free. Islamic banking institutions should have adequate procedures and controls in place to monitor these exposures.
- G** 7.5. An Islamic banking institution should ensure that its portfolios are not overly concentrated in large exposures.

8. Single Counterparty Exposure Limit

- S** 8.1. For the purpose of section 59(1) IFSA, an Islamic banking institution's SCEL shall be-
 - (a) 25% of the Islamic banking institution's Total Capital; and
 - (b) a limit as may be approved by the Bank which shall not exceed 50%⁷ of the Islamic banking institution's Total Capital, in the case of exposures to a counterparty which is a related banking entity (whether operating in or outside Malaysia).

⁶ A large exposure is defined in paragraph 6.2.

⁷ For the avoidance of doubt, notwithstanding any approval granted by the Bank under paragraph 8.1 (b), a banking institution's exposures to non-bank related corporations shall continue to be subject to the limit of 25% of the banking institution's Total Capital.

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- S** 8.2. An Islamic banking institution's total exposures to all related counterparties (including related banking entities and non-bank related corporations) shall not exceed 100% of the Islamic banking institution's Total Capital at any time.
- S** 8.3. For purposes of paragraph 8.1(b), an Islamic banking institution shall submit an application to the Bank to adopt a higher SCEL for its related banking entities and the Islamic banking institution must demonstrate to the Bank that the following are met:
- (a) there is no known or foreseeable legal or practical restriction⁸ in the related banking entity's jurisdiction for the related banking entity to transfer capital resources or repay liabilities to the Islamic banking institution;
 - (b) the related banking entity is subject to adequate prudential regulation and supervision by a regulatory authority in its jurisdiction and complies with an equivalent SCEL framework on a consolidated basis; and
 - (c) the Bank will have timely access to relevant information of the Islamic banking institution pertaining to its related banking entity as may be required for the Bank to make an informed assessment of risks associated with the Islamic banking institution's exposures to the related banking entity⁹.
- S** 8.4. Where the circumstances set out in paragraph 8.3(a), (b) or (c) change at any time after an approval by the Bank has been granted pursuant to paragraph 8.1(b), the approval may be revoked by the Bank.

⁸ Such as restrictions that may exist in regulations applicable to the related banking entity or in terms and conditions of shareholding agreements or capital instruments issued by the related banking entity.

⁹ As part of its assessment, the Bank will also consider the adequacy of the home/host supervisory cooperation arrangements in place with the relevant authority in the jurisdiction of the related banking entity, including the authority's ability and willingness to share detailed information concerning the related banking entity.

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- S** 8.5. For exposures funded by a Restricted Investment Account (RIA)¹⁰ or Unrestricted Investment Account (URIA)¹¹ which are maintained by an Islamic banking institution and where actual money has been paid into the RIA or URIA by the investment account holder, the Islamic banking institution shall exclude such exposure from the computation of the Islamic banking institution's SCEL.
- S** 8.6. An Islamic banking institution which is an investment account holder having an exposure arising from money paid into RIA or URIA maintained by another Islamic banking institution¹², must apply the look-through approach as described in Appendix 2 and compute such exposure as an exposure to the counterparty in relation to the underlying asset invested in by the other Islamic banking institution¹². The Islamic banking institution which is an investment account holder shall aggregate such exposure with all other exposures to such counterparty. In the event that relevant information of the underlying asset is not available, the Islamic banking institution must apply the method of measuring exposures as set out in Appendix 6.
- S** 8.7. For the purpose of computation of SCEL, an exposure that is guaranteed or protected by credit derivatives shall be treated as follows:
- (a) an Islamic banking institution may substitute¹³ its exposure to the direct counterparty with an exposure to the guarantor or protection provider, subject to fulfilling the criteria set out in paragraph 11.15 to 11.23 and Appendix 7. The Islamic banking institution shall aggregate the resulting exposure to the guarantor or protection provider with all its other

¹⁰ Restricted Investment Account (RIA) refers to an investment account where the investment account holder (IAH) provides a specific investment mandate to the Islamic banking institution with respect to the purpose, asset class, economic sector and period of the investment.

¹¹ Unrestricted Investment Account (URIA) refers to an investment account where the investment account holder provides the Islamic banking institution with the mandate to make the ultimate investment decision without specifying any particular restrictions or conditions.

¹² For the avoidance of doubt, this includes a reference to a licensed international Islamic bank and a prescribed institution approved to carry on Islamic banking business under section 129(1) of the Development Financial Institutions Act 2002.

¹³ For the avoidance of doubt, for the purpose of computation of SCEL, Islamic banking institution may also choose not to substitute the exposures to the guarantor or protection provider based on its internal policies on risk concentration.

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exposures to the guarantor or protection provider. In circumstances where the direct counterparty and its guarantor or protection provider are connected, the exposure should be treated as a single group exposure.

- (b) in the case of exposures guaranteed by either Credit Guarantee Corporation (CGC) or Danajamin, an Islamic banking institution is not required to aggregate such exposures with its other exposures to CGC or Danajamin respectively, until an event of default¹⁴ occurs. Upon the event of default, the Islamic banking institution must immediately aggregate the guaranteed exposure with its other direct exposures to CGC or Danajamin (refer to illustration in Appendix 3).

9. Exposures to a Single Counterparty

- G** 9.1. In accordance with section 59(2) IFSA, in computing the exposure to a single counterparty, an Islamic banking institution is required to aggregate its exposures to a single counterparty together with its exposures to persons connected to the single counterparty as they present a common risk to the Islamic banking institution, such that difficulties faced by either the single counterparty or persons connected to it may affect the funding or repayment capabilities of either one of them.
- S** 9.2. A person is regarded as “connected” to a single counterparty if-
 - (a) such person or the counterparty has control over the other, whether directly or indirectly, through shareholding¹⁵, shared management or directorship in accordance with Appendix 4; or
 - (b) such person or the counterparty is economically dependent on the other in accordance with Appendix 5, where the exposures are-
 - (i) material between the person and the counterparty (for

¹⁴ The definition of the ‘event of default’ is in accordance with the terms of the agreement between the counterparty and CGC or Danajamin.

¹⁵ For the avoidance of doubt, an exposure to be aggregated is not to be limited or proportional to the percentage of shareholding.

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scenarios (a) to (e) in Appendix 5); and

- (ii) the relationship between the person and the counterparty is not easily substituted in the short term (for scenario (e) in Appendix 5),

to the extent that failure or financial difficulties experienced by one is likely to significantly affect and impair the ability of the other to honour its financial obligations.

S 9.3. Where a single counterparty is connected to more than one group of persons, an Islamic banking institution must aggregate the exposure in each of the groups.

G 9.4. A situation described in paragraph 9.3 may arise where the counterparty-

- (a) is jointly controlled by two or more partners or persons that hold equal participation in the counterparty;
- (b) is a partner in more than one partnership and exercises control over these partnerships;
- (c) is dependent on a sole supplier for its business output and is also solely dependent on its parent for financial assistance; or
- (d) is the sole supplier to a group of persons.

S 9.5. Where persons are connected by virtue of a control relationship pursuant to paragraph 9.2(a), an Islamic banking institution may disaggregate its exposures to such connected person from the computation of the single counterparty exposure limit if the following criteria are met-

- (a) a single counterparty or such connected person has sufficient financial resources of its own to obtain credit facilities and to fully service its liabilities; and
- (b) a single counterparty or such connected person is not relied upon to support the liabilities of the other persons connected to the counterparty out of its financial resources.

Exposures to connected persons that are disaggregated shall be treated separately by the Islamic banking institution in computing an exposure to that connected person and be regarded as a separate single counterparty.

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- S** 9.6. An Islamic banking institution must have in place procedures for conducting economic dependence assessment, which shall at least cover its large exposures.
- G** 9.7. Islamic banking institutions should also endeavour to conduct economic dependence assessment for all other exposures considered material to the Islamic banking institution based on the Islamic banking institution's risk tolerance, to determine the extent of an exposure to a single counterparty.
- S** 9.8. Islamic banking institutions must document the assessments to support such disaggregation under paragraph 9.5. The documentation must be accessible to the internal control and risk management functions of the Islamic banking institution at all times.
- S** 9.9. Islamic banking institutions must exercise a reasonable degree of due diligence, including applying the principle of 'know your customer', in obtaining sufficient information on their counterparties to determine connectedness.

10. Exposures excluded from the computation of Single Counterparty Exposure Limit

- S** 10.1. The SCEL shall be applied to all exposures, notwithstanding the creditworthiness of a single counterparty and connected person or the quality of any underlying security, except for the following:
- (a) exposures of an overseas branch or subsidiary of an Islamic banking institution to the sovereign government or central banks in the jurisdiction where it is located, where the exposure is denominated in local currency and held to meet regulatory requirements imposed by the central bank in that jurisdiction;

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- (b) exposures to an Islamic banking institution licensed by the Bank¹⁶, or a development financial institution¹⁷, arising from interbank money market transactions;
- (c) exposures arising from granting of intra-day facilities; and
- (d) exposures deducted in the calculation of an Islamic banking institution's Total Capital as specified in Regulatory Adjustments of the *Capital Adequacy Framework for Islamic Banks (Capital Components)* (e.g. investments in financial subsidiaries).

S 10.2. In accordance with section 59(2) IFSA, any exposure to, and any exposure explicitly and unconditionally guaranteed by, the Bank or the Federal Government of Malaysia¹⁸ is to be excluded from the computation of the SCEL.

11. Methods of Measuring Exposures

- S** 11.1. For the purpose of determining compliance with the SCEL, exposures to a single counterparty must be measured in accordance with the applicable Financial Reporting Standards, unless specified otherwise.
- S** 11.2. **On-balance sheet exposures** must be measured in accordance with the applicable Financial Reporting Standards¹⁹, unless otherwise specified in this policy document.
- S** 11.3. For **off-balance sheet exposures**, the on-balance sheet credit equivalent amount shall be the nominal principal amount multiplied by a 100% credit conversion factor (CCF), except for the following:

¹⁶ This exclusion does not apply to an Islamic banking institution's exposures to another bank outside of Malaysia (e.g. a foreign bank's exposure to its parent bank overseas)

¹⁷ This refers to a development financial institution that is a prescribed institution under the Development Financial Institutions Act 2002.

¹⁸ For the avoidance of doubt, this exclusion does not include exposures to entities established by the Federal Government of Malaysia (e.g. MOF Inc, Khazanah Nasional) or the Bank that are not guaranteed explicitly by the Federal Government of Malaysia or the Bank.

¹⁹ For avoidance of doubt, the exposure amount must not be computed net of provisions.

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Underwriting arrangements

- (a) A 25% CCF²⁰ shall be applied for obligations under an on-going underwriting agreement and revolving underwriting facilities from the commitment date until issuance date, and thereafter a 50% CCF²⁰ shall be applied to any securities held up to a period of 30 days²¹ after the issuance of the securities. Any remaining securities held after such period must be computed at their full value as an exposure to the issuer.
- (b) Where an Islamic banking institution enters into a legally binding sub-underwriting agreement without recourse, the Islamic banking institution may record the amount of exposure net of the amount underwritten by the sub-underwriters. The exposures acquired by an Islamic banking institution that is a sub-underwriter under such arrangements must apply the treatment as specified in paragraph 11.3(a).
- (c) Where there is a legally binding placement (sale) agreement with an investor between the commitment and the issuance date of the securities, Islamic banking institutions can substitute the exposure from the issuer to the investor. Where the investor (buyer) of the securities is an Islamic banking institution, the acquired exposures must be recorded by the Islamic banking institution at 100% CCF, as it constitutes a commitment to purchase.
- (d) An Islamic banking institution must ensure that assurance from its legal counsel has been obtained with respect to the legal enforceability of all documentation involved in an underwriting arrangement and such documentation is subject to periodic reviews to confirm its on-going legal enforceability.

Unconditionally cancellable facilities

- (e) Any commitment that is unconditionally and immediately cancellable and revocable by the Islamic banking institution, or that effectively provide for automatic cancellation due to deterioration in a borrower's

²⁰ This does not apply to bought deals which involve an outright purchase by the Islamic banking institutions.

²¹ This grace period was reduced from 60 days effective from 1 March 2014.

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creditworthiness, at any time without prior notice that fulfils the criteria as specified in the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*, will be subject to 0% CCF.

- S** 11.4. For exposures arising from **derivative contracts**, the credit equivalent amount must be computed based on the current exposure method as specified in Appendix VI (Current Exposure Method) of the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*.
- S** 11.5. Islamic banking institutions may compute their exposure arising from derivative transactions with the same counterparty on a net basis, subject to satisfying the conditions and requirements on bilateral netting set out in Appendix VI (Bilateral Netting) in the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*.
- S** 11.6. For exposures under **repurchase agreements and sell-and-buy back agreements (SBBA)**, Islamic banking institutions shall compute-
- (a) an exposure to the issuer of the security pledged; and
 - (b) the net amount due from the counterparty when the value of the security pledged is higher than the financing value.
- S** 11.7. For exposures under **reverse repurchase agreements and reverse SBBAs**, Islamic banking institutions should compute the amount due from the counterparty, which may be off-set by the value of the security pledged if it qualifies as an eligible collateral as specified in paragraph 11.10.
- S** 11.8. Exposures under **agency trade transactions, principal trade transactions and free deliveries** related to investment bank operations shall be measured at-
- (a) the difference between the market value and transaction value of the contracts which is due from the counterparty for agency trade and principal trade transactions; and

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(b) the transaction value of the contracts which is due from the counterparty for free deliveries.

Exposures to the counterparties must be aggregated after the permitted settlement date as specified in Appendix VII (Capital Treatment for Failed Trades and Non-DvP Transactions) of the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*.

S 11.9. For **exposures to schemes with underlying assets** (e.g. investments in collective investment schemes and securitisation transaction), Islamic banking institution shall compute the exposures in accordance with Appendix 6.

S Collateralisation

11.10. For the purpose of compliance with the SCEL, an Islamic banking institution may reduce its exposures to a single counterparty to the extent that such exposures are secured by eligible collateral²², as follows:

- (a) cash deposits^{23, 24} (including certificates of deposit or comparable instruments issued by the Islamic banking institution)²⁵;
- (b) gold; or
- (c) securities issued by the Federal Government of Malaysia or the Bank.

S 11.11. The recognition of eligible collateral specified in paragraph 11.10 is subject to the following conditions-

- (a) the collateral must be pledged for the entire life of the exposure;
- (b) the collateral must be marked-to-market and revalued at a minimum frequency of 6 months;
- (c) all documentation used must be binding on all parties and legally

²² Collateral can be pledged by the counterparty or by a third party on behalf of the counterparty

²³ Cash pledged includes *`urbūn* (or earnest money held after a contract is established as collateral to guarantee contract performance) and *hamish jiddiyyah* (or security deposit held as collateral) in Islamic banking contracts (for example, *Ijārah*).

²⁴ Cash funded credit linked notes issued by the Islamic banking institution against exposures in the banking book which fulfill the criteria for credit derivatives will be treated as cash collateralised transactions.

²⁵ For the avoidance of doubt, non-principal protected structured investments are not recognised as eligible collateral.

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enforceable in all relevant jurisdictions. An Islamic banking institution is required to obtain assurance from its legal counsel with respect to the legal enforceability of the documentation. All documentation shall also be subjected to periodic reviews to ensure its on-going legal enforceability;

- (d) the legal mechanism by which the collateral is pledged or transferred must allow Islamic banking institutions to have the right to liquidate or take legal possession of the collateral in a timely manner in the event of default, insolvency or bankruptcy of the counterparty. Islamic banking institutions must have in place clear and robust procedures to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed and that collateral can be liquidated promptly. Islamic banking institutions must take steps to ensure legal enforceability of the collateral pledged at all times;
- (e) where collateral is held by a custodian, Islamic banking institutions must ensure good custody of the collateral and that the custodian segregates the collateral from its own assets; and
- (f) for Islamic banking exposures, collateral must be fully Shariah-compliant.

S 11.12. Islamic banking institutions shall not recognise a commitment to provide collateral as eligible credit risk mitigation for the purpose of compliance with the SCEL.

S 11.13. When the exposure and collateral are held in different currencies, Islamic banking institution shall make an adjustment to the collateral to take into account possible future fluctuations in exchange rates. A haircut, H_{FX} , shall be applied, as specified in paragraph 11.18.

S 11.14. Recognition of a single collateral to cover multiple exposures of one or more counterparties (for example, a parent company provides a single collateral to cover the borrowings of several entities within its group) is only allowed for transactions entered into with the same Islamic banking institution and if the collateral pledged is exclusive to that Islamic banking institution. In addition,

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Islamic banking institutions must ensure that the collateral is of sufficient value to cover the aggregate value of all the exposures and that the conditions specified in paragraph 11.11 are adhered to.

Guarantees and Credit Derivatives

- S** 11.15. An Islamic banking institution may substitute its exposure to the direct counterparty with an exposure to the guarantor or protection provider provided that the guarantor or protection provider is of a better rating than the direct counterparty, or equal rating if the direct counterparty is of the highest rating (e.g. AAA).
- S** 11.16. Islamic banking institution may only substitute exposures in accordance with paragraph 8.7(a) where the exposure is protected by the following:
- (a) a guarantee which satisfies the conditions in Appendix 7; or
 - (b) single name credit default swaps or single name total return swaps²⁶, which satisfies the conditions in Appendix 7. Substitution is not permitted where Islamic banking institutions buy credit protection through a single name total return swap and record the net payments received on the swap as net income, but does not record an offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves).
- S** 11.17. Islamic banking institutions must demonstrate that any additional minimum requirements of risk management practices outlined in the Bank's current policy documents are met²⁷. For purposes of paragraph 8.6(a), banking institutions shall at all times comply with any additional risk management requirements as may be specified by the Bank.

²⁶ For the avoidance of doubt, nth to default (e.g. first to default) credit derivatives and credit derivatives allowing for cash settlement are not recognised as credit risk mitigants for the computation of SCEL.

²⁷ *Guidelines on Minimum Standard on Risk Management Practices for Derivatives (1996)* and *Guidelines on Regulatory Treatment for Credit Derivatives Transaction (2005)*.

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Currency Mismatches

- S** 11.18. Where the collateral, guarantee or credit protection is denominated in a currency different from that in which the exposure is denominated, a haircut, H_{FX} , shall be applied to the amount that can be substituted, as follows:

$$Exposure = G \times (1 - H_{FX})$$

where-

- G** = Nominal amount of the collateral, guarantee or credit protection
- H_{FX}** = 8% supervisory haircut for currency mismatch between the credit protection and the substituted obligation.

Maturity Mismatches²⁸

- S** 11.19. Islamic banking institutions can only recognize credit derivatives²⁹ with maturity mismatches where their original maturities are greater than or equal to one year. As such, the maturity of credit derivatives for exposure with original maturities of less than one year must be matched to be recognised. In all cases, Islamic banking institutions shall not recognize credit derivatives with maturity mismatches where they have a residual maturity of three months or less.
- S** 11.20. For the purpose of paragraph 11.19, the effective maturity of the underlying exposure shall be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period.
- S** 11.21. For a credit derivative, Islamic banking institutions shall take into account embedded options which may reduce the term of the credit derivatives so that the shortest possible effective maturity is used. Specifically-
- (a) where a call is at the discretion of the protection seller, the maturity will always be at the first call date.

²⁸ A maturity mismatch occurs when the residual maturity of credit protection is less than that of the underlying exposure

²⁹ For the avoidance of doubt, no maturity mismatch is allowed for guarantees.

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- (b) if the call is at the discretion of the protection buying bank but the terms of the arrangement at origination of the protection contain a positive incentive for the Islamic banking institution to call the transaction before contractual maturity, the remaining time to the first call date will be deemed to be the effective maturity.

- S** 11.22. When there is a maturity mismatch with credit derivatives the following adjustment will be applied-

$$P_a = P \times \frac{(t - 0.25)}{(T - 0.25)}$$

Where-

- P_a = Value of the credit derivatives adjusted for maturity mismatch
- P = Protection amount adjusted for any haircuts
- t = Min (T, residual maturity of the credit derivatives arrangement) expressed in years
- T = Min (5, residual maturity of the exposure) expressed in years

- S** 11.23. Where credit derivatives provided by a single protection provider has different maturities, Islamic banking institution must divide these into separate portions.

12. Compliance with the Single Counterparty Exposure Limit

- S** 12.1. The single counterparty exposure limit must be observed by Islamic banking institutions at all times. Islamic banking institutions must put in place appropriate procedures and processes to facilitate on-going compliance. This must include adequate monitoring and reporting mechanisms to ensure adherence to this policy.

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- S** 12.2. The Bank considers any breach of the SCEL as a serious matter and the Bank reserves the right to take any enforcement action under the IFSA for such breach. Nonetheless, Islamic banking institutions must notify the Bank immediately of any breach of the SCEL, together with an explanation of the cause of the breach and remedial actions taken or to be taken (with a proposed time frame) to bring the exposures within the SCEL. During the rationalisation period, the Islamic banking institution shall not increase its exposures to the affected counterparty.

13. Transitional Arrangements

- S** 13.1. To facilitate implementation and in recognition that Islamic banking institutions may require time to fully comply with the requirements in this policy document, Islamic banking institutions have until 1 September 2014 to put in place systems to support aggregation and monitoring of exposures to counterparties and persons connected to them.
- S** 13.2. All exposures as at the effective date of this policy document which exceed the SCEL based on requirements specified herein shall be brought into compliance by 1 March 2015, subject to any specific transitional arrangements in respect of such exposures as may be approved by the Bank on a case-by-case basis.
- S** 13.3. In the case of exposures by Islamic banking institutions to related banking entities and where the Bank has granted an approval for the Islamic banking institution to maintain a higher SCEL in accordance with paragraph 8.1(b), the Islamic banking institution must ensure that all exposures that are in excess of the approved limit are brought into compliance by 1 January 2017.
- S** 13.4. Fixed term financing with agreed repayment schedules granted before 1 March 2013 and fix term financing which terms have been agreed upon before 1 March 2013 and approved by 1 June 2013 are allowed to run to maturity notwithstanding a breach of the SCEL.

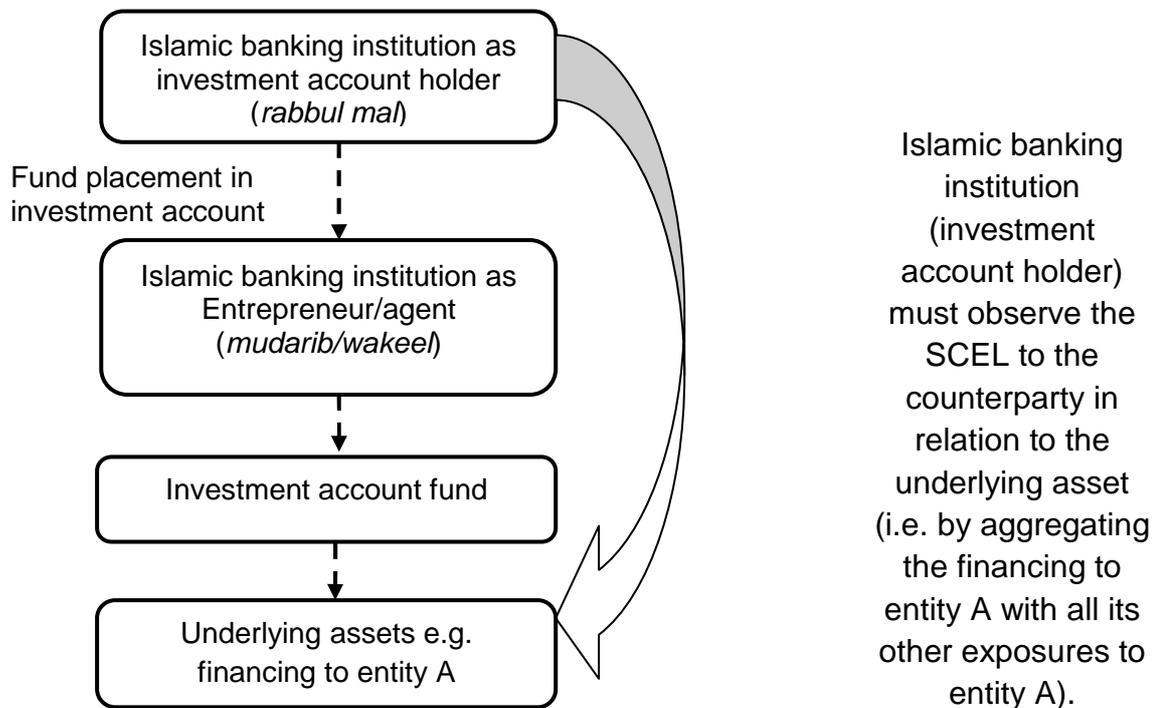
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APPENDICES

Appendix 1 Policy Document Superseded

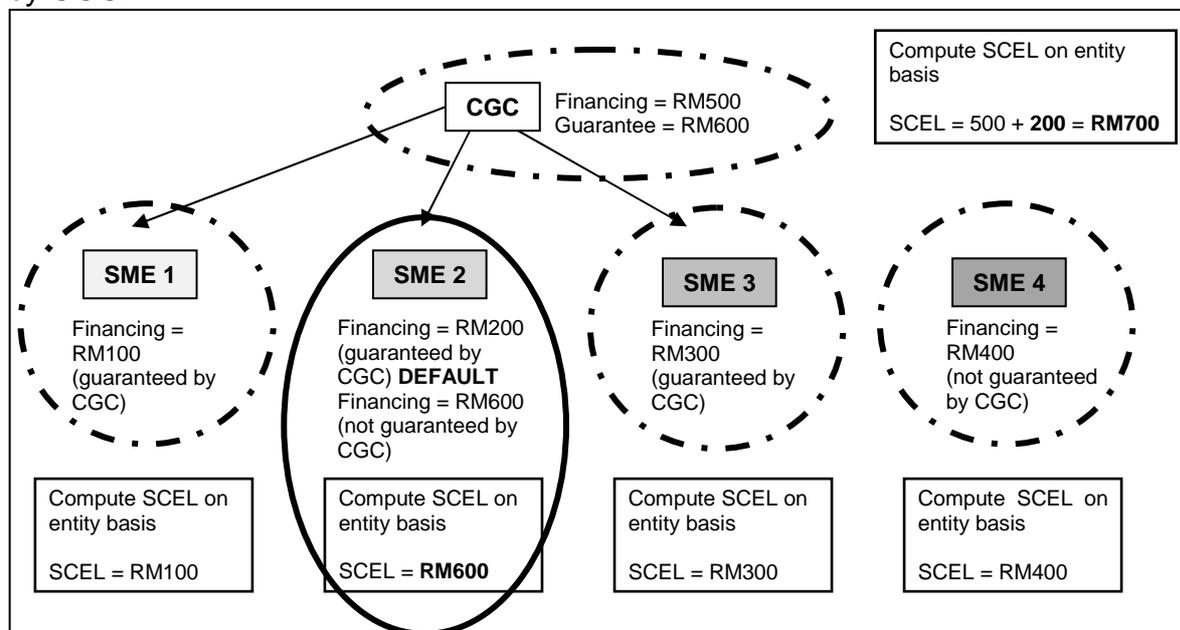
1. *Single Counterparty Exposure Limit for Islamic Banking Institutions* issued on 17 December 2013.

Appendix 2 Look-through approach for exposures funded by RIA and URIA



Appendix 3 Exposures to and Guarantees Provided by the CGC and Danajamin

This example illustrates the computation of exposures to SMEs that are guaranteed by CGC.



An Islamic banking institution has granted the following financing:

	Counterparty	Financing Amount (RM)	Financing Amount Guaranteed by CGC (RM)	Financing Amount Aggregated for SCEL on an Entity Basis (RM)
1.	CGC	500		500
2.	SME 1	100	100	100
3.	SME 2	800	200	800
4.	SME 3	300	300	300
5.	SME 4	400		400

In the event that the financing granted to SME 2 defaults, the guarantee provided by CGC is crystallised:

	Counterparty	Financing Amount (RM)	Financing Amount Guaranteed by CGC (RM)	Financing Amount Aggregated for SCEL on an Entity Basis (RM)
1.	CGC	500 + 200		700
2.	SME 1	100	100	100
3.	SME 2	800 - 200	200	600
4.	SME 3	300	300	300
5.	SME 4	400		400

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Appendix 4 Determination of “connected” on the basis of control

1. Control is deemed to exist when a counterparty or another person-
 - a) is able to direct the activities of the other entity so as to obtain benefits from its activities;
 - b) is able to decide on crucial transactions such as the transfer of profit or loss of the other;
 - c) is able to appoint or remove the majority of directors, the members of the board of directors or equivalent governing body of an entity where control of the entity is exercised by that board or governing body;
 - d) is able to cast the majority of votes at meetings of the board of directors, general assembly or equivalent governing body where control of the entity is exercised by that board or body; or
 - e) is able to co-ordinate the management of an undertaking with that of other undertakings in pursuit of a common objective, for instance, in the case where the same persons are involved in the management or board of two or more undertakings.

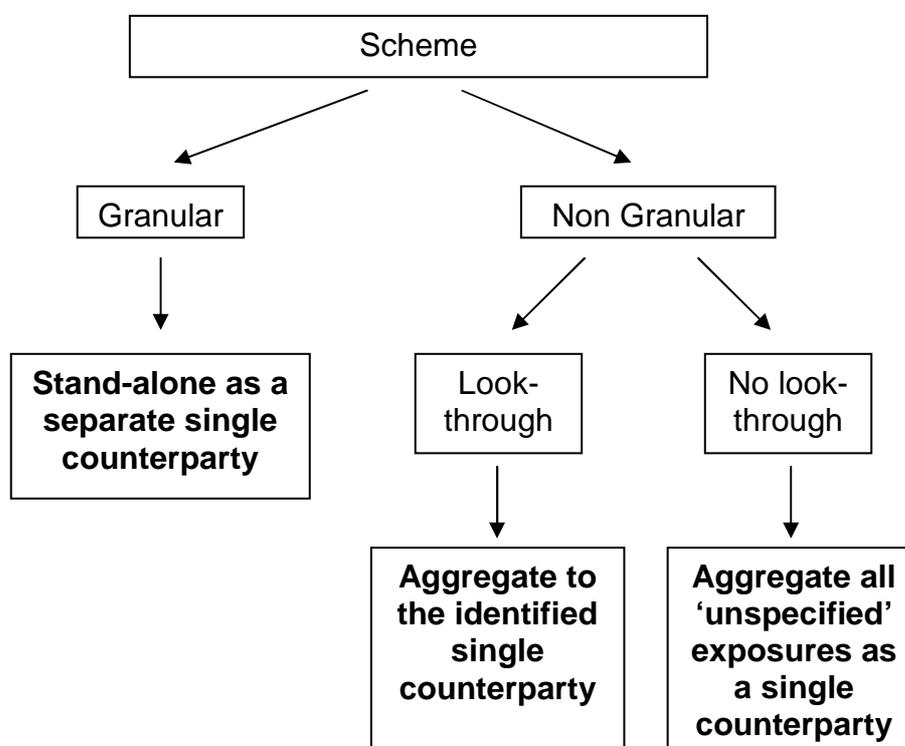
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Appendix 5 Determination of “connected” on the basis of economic dependence

1. The presence of the following factors may be indicative of economic dependence between a counterparty and another party-
 - (a) having the same expected source of repayments;
 - (b) the existence of cross guarantees between the counterparties;
 - (c) significant associations or relationships, for example, the sharing of common marketing and/or branding platform;
 - (d) a counterparty and his/her spouse/child/family corporation; or
 - (e) commercial interdependence between the counterparties, for example-
 - (i) exclusive relationship between a producer and a vendor;
 - (ii) the owner of a residential/commercial property and the tenant; and
 - (iii) significant part of production/output is for one single counterparty.

2. Islamic banking institutions should consider other relevant aggregation criteria based on institutional experience and judgement which may be indicative of connectedness between counterparties.

Appendix 6 Method of Measuring Exposures to Schemes with Underlying Assets



1. Islamic banking institutions must determine if the underlying assets in the scheme are **granular**. The scheme is considered granular when the largest exposure value of the underlying assets is equal to or less than 5% of the total value of the scheme, at the point of transaction. Exposures under each of such schemes may be treated as stand-alone exposures to a single counterparty.
2. If the underlying assets are **not granular**, Islamic banking institutions must apply the look-through approach and aggregate their exposures to the individual counterparty of the underlying pool of assets, subject to the ability to identify the issuers and value the assets at all times.
3. For exposures that qualify for the **look-through** approach, the exposure value must be aggregated to the issuer of each asset based on the relative size of the issuers' contribution to the scheme. For static portfolios where the

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underlying assets do not change over time, an assessment can be made once and does not need to be monitored in the future. For dynamic portfolios, monitoring must be carried out at regular intervals, at least every 6 months.

4. If the Islamic banking institution is **unable to look-through** the scheme, the exposures shall be classified as 'unspecified' exposures and aggregated with all other similar exposures arising from other schemes and regarded as a single counterparty.

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Appendix 7 Requirements for Recognition of Guarantees and Credit Derivatives

1. For purpose of paragraph 11.16, a guarantee or credit derivative shall meet the following conditions-
 - (a) the guarantee undertaking or credit derivative must be explicitly documented and all documentation used must be binding on all parties and legally enforceable in all relevant jurisdictions. An Islamic banking institution is required to obtain assurance from legal counsel with respect to the legal enforceability of the documentation. All documentation shall also be subjected to periodic reviews to confirm its on-going enforceability;
 - (b) the guarantee or credit derivative must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures, so that the extent of the cover is clearly defined and cannot be disputed;
 - (c) the credit protection contract must be irrevocable. The protection provider must also not have the right to unilaterally cancel the credit cover or increase the effective cost of cover as a result of deteriorating credit quality in the substituted exposure;
 - (d) the contract must not have any clause or provision outside the direct control of the Islamic banking institution that prevents the protection provider from being obliged to pay in a timely manner in the event that the original counterparty fails to make the payment(s) due; and
 - (e) where the amount guaranteed or credit protection is less than the amount of the underlying exposure, the unsecured portion of the underlying exposure shall not be substituted to the guarantor or the protection provider.

2. Islamic banking institutions shall not recognise a commitment to provide guarantee as eligible credit risk mitigation for the purpose of compliance with the SCEL.

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Additional Operational Requirement for Guarantees

3. On the default/non-payment of the counterparty, the Islamic banking institution must pursue the guarantor for any monies outstanding under the documentation governing the transaction, in a timely manner. The documentation shall provide that the guarantor must pay at once all monies to the Islamic banking institution, or the guarantor must assume the future payment obligations of the counterparty covered by the guarantee.

Additional Operational Requirements for Credit Derivatives

4. A credit derivative contract recognised for substitution shall meet the following conditions-
 - (a) Credit events specified by the contracting parties must at least cover-
 - (i) failure to pay the amounts due under terms of the substituted obligation at the time of default;
 - (ii) bankruptcy, insolvency and inability of the borrower to pay its debts, or its failure or admission in writing of its inability generally to pay its debt as they become due, and analogous events; and
 - (iii) restructuring of the substituted obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. charge off, provision or other similar debt to the profit and loss account).
 - (b) The credit derivatives shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay, subject to the provision of paragraphs 11.19 and 11.20;
 - (c) If the contract requires the protection purchaser to transfer the substituted obligation to the protection provider at settlement, the terms of the substituted obligation must provide that consent to such transfer should not be unreasonably withheld; and
 - (d) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must

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not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.