

The Executive Bylaws  
Module Seventeen

# Capital Adequacy Regulations for Licensed Persons



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## List of Abbreviations

Abbreviation	Description
<b>AT1</b>	Additional Tier 1
<b>AUM</b>	Assets under Management
<b>CCF</b>	Credit Conversion Factor
<b>CCP</b>	Central Counterparty
<b>CCR</b>	Counterparty Credit Risk
<b>CET1</b>	Common equity tier 1
<b>CIS</b>	Collective Investment Scheme
<b>CMA</b>	Capital Market Authority
<b>CMV</b>	Current Market Value
<b>CPSS</b>	Committee on Payments and Settlement Systems
<b>CQG</b>	Credit Quality Grade
<b>CRM</b>	Credit Risk Mitigation
<b>CSD</b>	Central Securities Depository
<b>CVA</b>	Credit Value Adjustment
<b>ECAI</b>	External Credit Assessment Institution
<b>FMI</b>	Financial Market Infrastructure
<b>FRA</b>	Forward Rate Agreement
<b>FVTPL</b>	Fair value through profit or loss
<b>FVOCI</b>	Fair Value through Other Comprehensive Income
<b>FX</b>	Foreign Exchange
<b>FXNET</b>	Foreign Exchange Netting and Close-Out Agreement
<b>GCC</b>	Gulf Cooperation Council
<b>GMRA</b>	Global Master Repurchase Agreement
<b>ICOM</b>	International Currency Option Master Agreement
<b>IFEMA</b>	International Foreign Exchange Master Agreement
<b>IFRS</b>	International Financial Reporting Standards
<b>IOSCO</b>	International Organization of Securities Commissions
<b>ISDA</b>	International Swaps and Derivatives Association
<b>KD</b>	Kuwaiti Dinar
<b>LIBOR</b>	London Inter-bank Offered Rate

Abbreviation	Description
<b>NGR</b>	Net-to-Gross Ratio
<b>OBS</b>	Off-Balance Sheet
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>OTC</b>	Over the Counter
<b>PSE</b>	Public Sector Entity
<b>QCCP</b>	Qualifying Central Counterparty
<b>RC</b>	Replacement Cost
<b>S&amp;P</b>	Standard & Poor
<b>SFT</b>	Securities Financing Transaction
<b>SPV</b>	Special Purpose Vehicle
<b>SSF</b>	Securities Settlement Facilities
<b>T2</b>	Tier 2
<b>TRSA</b>	Tri-partite Repo Service Agreement
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

## Definitions

- No.** The following definitions and Abbreviations are used for the scope of this module only, and are independent from Module One “Glossary” of the executive bylaws of law No. (7) of 2010 regarding the establishment of the capital markets authority and regulating securities activities and their amendments:
- 1** “**Licensed person**” a natural or corporate entity that has a license from the Authority to practice one or more of the Securities Activities provided for in Article (1-2) of chapter one of Module Five (Securities Activities and Registered Persons) of these Bylaws, or a license to practice securities exchange activities provided for in article (1-2-2) of chapter one of module Four (Securities Exchanges and Clearing Agencies) of these Bylaws, or a license to practice clearing agency provided for in article (2-2-2) of chapter Two of module Four (Securities Exchanges and Clearing Agencies) of these Bylaws.
  - 2** “**PSE**” PSEs include those entities owned by the government, excluding the subsidiaries of such institutions undertaking commercial activities.
  - 3** “**Recognised exchanges**” means those stock exchanges recognised by the CMA for capital adequacy purposes.
  - 4** “**Securities Firm**” means any entity licensed and supervised by relevant securities regulator. Domestically, these include all financial entities including investment companies and funds that are under the supervision of the Capital Markets Authority. Securities brokers are also included under this definition.
  - 5** “**External Credit Assessment Institution (ECAI)**” means an external credit assessment institution recognised by the CMA for capital adequacy purposes.
  - 6** “**Credit Quality Grade**” means a grade represented by six grades (i.e. 1-6) that will be used for determining the appropriate risk charge for a rated exposure.
  - 7** “**CCF**” means credit conversion factor, by which the principal amount of an off-balance sheet exposure is multiplied to derive the credit equivalent amount.
  - 8** “**Counterparty Credit Risk (CCR)**” is the risk that a counterparty will fail to meet its contractual obligations. An economic loss would occur if a transaction or portfolio of transactions with the counterparty have a positive economic value at the time of failure/default.
  - 9** “**Central counterparty (CCP)**” is the party that mediates between counterparties by becoming the buyer to every seller and the seller to every buyer in the market.

- 10** **“Clearing agency member”** a corporate entity registered into a system that offers any service offered by a clearing agency such as clearing centre, or central securities depository (CSD), and is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.
- 11** **“Credit Valuation Adjustment”** is an adjustment to the valuation of the portfolio of trades with a counterparty. This adjustment reflects the credit risk that may arise due to any failure to perform on contractual agreements with a counterparty.
- 12** **“Credit Risk Mitigation”** refers to techniques that licensed persons use to reduce the credit risk of their exposures.
- 13** **“Financial Institutions”** are local companies, whether listed or not, in the banking sector, insurance sector, licensed persons by the CMA sector (except for companies whose activities are limited to the following activities: Investment Advisor, Investment Controller, Valuation of Assets), and financial services companies, provided that they include at least the following:
- Financing
  - Foreign Exchange
  - Debt Collection
- 14** **“Principal Amount”** means the amount of any outstanding claim (excluding any interest and other expenses) on, or contingent liability in respect of, the relevant counterparty.
- 15** **“Qualifying central counterparty”** is a licensed person that is licensed to operate as a CCP 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 CPSS-IOSCO Principles for Financial Market Infrastructures.
- 16** **“Offsetting transaction”** means the transaction leg between the clearing agency member and the CCP when the clearing agency member acts on behalf of a client (e.g. when a clearing member clears or novates a client’s trade).
- 17** **“Gross income”** is defined as gross interest income plus dividend income plus fees and commission income plus income from other activities, gross of operating expenses (including fees paid for outsourcing services) and before any provisions. It excludes profit/loss arising from extraordinary or irregular items and income derived from insurance exposures.
- 18** **“Off-balance sheet Activities”** are licensed persons’ business that does not generally involve booking assets or liabilities. Examples include trading in swaps, options, futures and foreign exchange forwards.



- 19 “**Current Exposure**” is the positive value of a transaction or portfolio of transactions within a netting set with a counterparty (if existing) and is often also called Replacement Cost.
- 20 “**Current Market Value (CMV)**” refers to the net market value of the portfolio of transactions within the netting set with the counterparty. Both positive and negative market values are used in computing CMV.
- 21 “**Marking-To-Market**” is the process of revaluing a portfolio on the basis of prevailing market prices.
- 22 “**Holding Period**” is the length of time that a licensed person is assumed to hold a given financial instrument for the purpose of calculating the sensitivity of price volatility.
- 23 “**Currency Swap**” is a transaction involving an exchange of principal of two different currencies. Interest payments are exchanged over the life of the contract and the principal amounts are repaid either at maturity or according to a predetermined amortisation schedule.
- 24 “**Observation Period**” is the period over which it is judged appropriate to review historical data in setting a capital requirement. For example, the requirement might be set according to observed price changes over the past five years.
- 25 “**Variation Margin**” means a clearing agency member’s or client’s funded collateral posted on a daily or intraday basis to a CCP based upon price movements of their transactions.
- 26 “**Volatility**” is a measure of the variability of the price of an asset, usually defined as the annualised standard deviation of the natural log of asset prices.
- 27 “**Structural Positions**” include the following:
- a. Any position arising from an instrument which qualifies to be included in the licensed person’s capital base.
  - b. Any position entered into in relation to the net investment of a capital nature in a self-sustaining subsidiary, the accounting consequence of which is to reduce or eliminate what would otherwise be a movement in the foreign currency translation reserve.
- 28 “**Initial Margin**” means a clearing agency member’s or client’s funded collateral posted to the CCP to mitigate the potential future exposure of the CCP to the clearing agency member arising from the possible future change in the value of their transactions.

- 29 **“Interest Rate Risk”** is the risk that changes in market interest rates might adversely affect a licensed person’s financial condition.
- 30 **“Operational Risk”** is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.
- 31 **“OTC (Over-The-Counter)”** is trading in financial instruments transacted off organised exchanges outside the state of Kuwait. Generally, the parties negotiate all details of the transactions, or agree to certain simplifying market conventions.
- 32 **“Repo-style transactions”** means transactions involving the sale and repurchase (“repo”) of assets, purchase and resale (“reverse repo”) of assets, as well as securities lending and securities borrowing. For capital adequacy purposes, the term “repo-style transactions” is generally taken to refer to any of the following transactions of a licensed person:
- a. Sale & repurchase (“repo”) of securities - the licensed person agrees to sell securities to a third-party for cash with a commitment to repurchase the securities at an agreed price on an agreed future date.
  - b. Securities lending - the licensed person lends securities to a third-party and receives either cash or other securities from that party in exchange as collateral.
  - c. Purchase and resale (“reverse repo”) of securities - the licensed person agrees to acquire securities from a third-party for cash with a commitment to resell the securities at an agreed price on an agreed future date (i.e. the reverse of repo transactions).
  - d. Securities borrowing - the licensed person borrows securities from a third-party and gives cash or other securities to that party in exchange as collateral.
- 33 **“Securitisation exposure”**: The exposures of a licensed person which are exposed to securitisation are referred to as securitisation exposures. These exposures get created when licensed persons invest in securities issued on an underlying asset pool (the securitised pool). Hence the exposures are said to be exposed to securitisation. Securitisation exposures include:
- a. On-balance sheet exposure to securities (which are issued based on the pool of securitised exposures) and can include but is not limited to asset-backed securities, mortgage-backed securities and collateralised debt obligations.
  - b. Any off-balance sheet exposure to a securitisation which can include but is not limited to credit enhancements, liquidity facilities, credit risk mitigants (guarantees, derivatives) or Tranching cover.
- 34 **“Credit enhancement”** refers to enhancing the credit-worthiness of a Bond or Sukuk by adding collateral or guarantees, in addition, it is a contractual arrangement in which a licensed person retains securitisation exposures (like an investing licensed person) and in substance, provides some degree of protection to other investors of the transaction by way of enhancement of the credit quality of the securitisation structure. An example is providing liquidity facility or cash advance services to the securitisation structure as an added degree of protection.

- 35** “**Special purpose vehicle (SPV)**” a company set up for a special purpose such as to issue a Sukuk or to undertake other securitization transactions, or issue contractual Collective Investment Scheme units. The company is subject to the rules and conditions provided for in the Law and these Bylaws.
- 36** “**Convertible Bond**” is a bond which gives the investor the option to switch into equity at a later date.
- 37** “**Default funds**”, also known as clearing deposits or guaranty fund contributions (or any other names), are clearing agency members’ funded or unfunded contributions towards, or underwriting of, a CCP’s mutualised loss sharing arrangements.
- 38** “**Delta**” is the expected change of an option’s price as a proportion of a small change in the price of the underlying instrument.
- 39** “**Gamma**” is the sensitivity of an option’s delta to small changes in the price of the underlying; alternatively, the sensitivity of a delta-hedged position to large unit changes in the price of the underlying.
- 40** “**In-the-Money**”: An Option contracts are in the money when there is a net financial benefit to be derived from exercising the option immediately. A call option is in the money when the price of the underlying instrument is above the exercise price and a put option is in the money when the price of the underlying instrument is below the exercise price.
- 41** “**Long Option Position**” is the position of a licensed person who has purchased an option regardless of whether it is a put or a call.
- 42** “**Margin Agreement**” is a contractual agreement or provisions to an agreement under which one counterparty must supply collateral to a second counterparty when an exposure of that second counterparty to the first counterparty exceeds a specified level.
- 43** “**Margin Lending Transactions**” are transactions in which a licensed person extends credit in connection with the purchase, sale, carrying or trading of securities. Margin lending transactions do not include other loans that happen to be secured by securities collateral. Generally, in margin lending transactions, the loan amount is collateralised by securities whose value is greater than the amount of the loan.
- 44** “**Out-of-the-Money**”: An option contract is out of the money when there is no benefit to be derived from exercising the option immediately. A call option is out of the money when the price of the underlying is below the option’s exercise price. A put option is out of the money when the price of the underlying is above the option’s exercise price.

- 45 **“Securities Financing Transactions (SFTs)”** are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements.
- 46 **“Short Option Position”** is the position of a Licensed Person who has sold or written an option. The writer’s maximum potential profit is the premium received.

**Chapter One**  
Introduction

**A. Introduction**

**Article 1-1**

The CMA is introducing Capital Adequacy Regulation for Licensed Persons (“Guidelines”) by issuing this paper.

**Article 1-2**

The regulation introduces risk based regulatory capital requirements and mandates licensed persons to hold capital proportionate to the risks faced by them.

**Article 1-3**

These guidelines shall be read in conjunction with Law No. 7 of 2010 and its executive bylaw and its amendments, and other valid regulations and resolutions issued by CMA.

## Chapter Two

### Scope of Application

2

#### A. Scope of Application

<b>Article 2-1</b>	Instructions in these Guidelines are applicable to all locally incorporated entities licensed by CMA and operating in the State of Kuwait, hereinafter referred to as ' <u>licensed persons</u> '.
<b>Article 2-2</b>	<u>Licensed persons</u> are required to observe these regulations on a consolidated level, where capital requirements should be met at group level.
<b>Article 2-3</b>	<u>Licensed persons</u> are required to report their capital adequacy in light of these guidelines on a quarterly basis at consolidated level, and shall be required to submit the report and its templates to CMA within forty five days from the end date of the periodical financial reporting period , and within ninety days from the end date of the annual financial period, where it has to also be reviewed by a registered auditor registered within CMA.
<b>Article 2-4</b>	Both quantitative and qualitative requirements outlined in these guidelines are applicable to all <u>licensed persons</u> .
<b>Article 2-5</b>	Branches of foreign entities operating in Kuwait, that are licensed by CMA, will only be subject to the following qualitative requirements. Each of these entities must: <ul style="list-style-type: none"> <li>a. ensure that it has and maintains, at all times, liquid assets and access to financial resources which are adequate in relation to the nature, size and complexity of its business both, as to amount and quality to ensure that there is no significant risk that liabilities cannot be met as they fall due;</li> <li>b. ensure that it complies at all times with its Home State Regulator's prudential requirements;</li> <li>c. submit to the CMA a copy of capital adequacy summary report submitted to its Home State Regulator within ten business days of the due date for submission to that regulator;</li> <li>d. in the event of any anticipated or actual breach of any prudential requirements set by its Home State Regulator, notify the CMA immediately with any relevant documents;</li> <li>e. establish and maintain a senior management structure to manage risks as provided for in chapter six of module Fifteen (Corporate Governance);</li> <li>f. identify, assess, measure, mitigate, control, monitor and report all material risks; and</li> <li>g. monitor overall Risk profile on a regular basis.</li> </ul>
<b>Article 2-6</b>	This module "Guidelines" is not applicable to all banks operating in the state of Kuwait, and they need to implement CBK guidelines in this regard.

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**B. Licensed persons exempt from Risk based Capital Requirement**

**Article 2-7**

Any licensed persons that conducts only one or more of the following activities is exempt from the Risk Based Capital Requirements defined in these guidelines:

- a. Asset Valuation.
- b. Investment Advisor.
- c. Credit Rating Agency.
- d. Investment Controller.

Licensed persons whose activities are limited to the activities referred to above are also exempt from submitting quarterly capital adequacy reports for the periodical financial periods, provided that they submit capital adequacy reports for the annual financial period in accordance with the deadline specified in Article (2-3) of these guidelines.

**C. Financial Market Infrastructure**

**Article 2-8**

Financial Market Infrastructure (FMI) and Securities Exchanges are systemically important institutions responsible for providing clearing agency, settlement and recording of monetary and other financial transactions.

**Article 2-9**

For purposes of these guidelines, any licensed person conducting activities related to and acting as Central Securities Depository (CSD), Securities Settlement Facilities (SSF) or Central Counterparty (CCP) will be defined as an FMI. Securities Exchanges will also be treated as FMI for these guidelines.

## Chapter Three

### Regulatory Capital Requirements

3

#### A. Regulatory Capital Requirement

##### Article 3-1

Licensed persons must ensure that, at all times, their actual Eligible Regulatory Capital, as defined in next Section 3B - "Definition of Eligible Regulatory Capital", is in excess of their Risk Based Capital Requirement on an ongoing basis.

##### Article 3-2

Risk Based Capital Requirement is the sum of Risk Based Capital Charges calculated for each of the following as per this guidelines in; Chapter 4 "Risk Based Capital Charges" and Chapter 5 "Financial Market Infrastructures", and Chapter 6 "Capital Requirements for Islamic Financing and Investment Instruments":

- a. Market Risk.
- b. Operational Risk.
- c. Investment Risk.
- d. Credit Risk.
- e. Counterparty Credit Risk.
- f. Securities Underwriting Risk.
- g. Securities Financing Transactions.
- h. Risk charge for Assets Under Management.
- i. Other Exposures.
- j. Financial Market Infrastructure (described in Chapter 5).
- k. Capital Requirements for Islamic Financing and Investment Instruments (Chapter Six).

#### B. Definition of Eligible Regulatory Capital

##### Article 3-3

Eligible Regulatory Capital shall consist of the sum of the following items:

- a. Common Equity Tier 1 ("CET 1") capital, subject to eligibility criteria outlined in Articles 3-5 to 3-7.
- b. Additional Tier 1 ("AT1") capital, subject to eligibility criteria outlined in Articles 3-10 to 3-12 (if applicable).
- c. Tier 2 ("T2") capital, subject to eligibility criteria outlined in Articles 3-13 to 3-15 (if applicable).
- d. Capital instruments issued by consolidated subsidiaries of the licensed person, and held by third parties (i.e. minority interest), that meet the criteria for inclusion in CET 1, AT1 or T2 capital. See Article 3-20 for the relevant criteria.
- e. Regulatory adjustments applied in the calculation of CET1 capital as listed in Article 3-22 to 3-29.

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**Article 3-4**

In addition to article 3-1, where Eligible Regulatory Capital has to be in excess of Risk Based Capital Requirement, the following criteria also applies (where applicable):

- a. At least 80% to be Tier 1 capital (i.e. sum of CET1 and AT1 capital), if applicable (i.e. where the licensed person has eligible Tier 2 capital).
- b. At least 60% to be CET 1 capital, if applicable (i.e. where the licensed person has eligible AT1 and Tier 2 capital).

**B.1 Common Equity Tier 1 Capital (CET 1)**

**Article 3-5**

CET 1 capital shall consist of the following items:

- a. Common shares issued by the licensed person that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies).
- b. Stock surplus (share premium) resulting from the issue of instruments included in CET 1.
- c. Retained earnings, which is the amount of net earnings carried forward as of the date on which the report is prepared, and reinvested in the core business. It shall be recognised and included in the calculation of CET1.
- d. Accumulated other comprehensive income and other disclosed reserves. The treatment of unrealised gains shall be subject to applicable accounting practices in the State of Kuwait.

**Article 3-6**

For licensed persons structured as joint stock companies the criteria must be met solely with common shares. In the rare cases where licensed persons need to issue non-voting common shares as part of CET 1, they must be identical to voting common shares of the issuing licensed person in all respects except the absence of voting rights.

**Article 3-7**

For an instrument to be included in CET 1 capital it must meet all of the criteria that follow:

- a. Represents the most subordinated claim in liquidation of the licensed person.
- b. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior exposures have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
- c. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
- d. The licensed person does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
- e. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid-in at issuance and is not subject to a contractual cap.
- f. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.
- g. Distributions are paid only after all legal and contractual obligations have been met, and payments on more senior capital instruments have been made.
- h. The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.
- i. The paid-in amount is classified as equity (i.e. not liabilities) under the relevant accounting standards.
- j. It is directly issued and paid-in and the licensed person cannot directly or indirectly have funded the purchase of the instrument.
- k. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.
- l. It is only issued with the approval of the owners of the issuing licensed person, either given directly by the owners or by other persons duly authorised by the owners.
- m. It is clearly and separately disclosed on the licensed person's balance sheet.

### Additional Tier 1 and Tier 2 Capital

#### Article 3-8

The following articles 3-10 to 3-19 with respect to Additional Tier 1 Capital and Tier 2 Capital inclusion in Eligible Regulatory Capital are only applicable to licensed persons that have issued capital instruments that would qualify as Additional Tier 1 Capital or Tier 2 Capital.

#### Article 3-9

In any case the issuance of Additional Tier 1 or Tier 2 capital instruments will be subject to discretion and approval of CMA in addition to the minimum criteria described below.

### B.2 Additional Tier 1 Capital

#### Article 3-10

Additional Tier 1 capital consists of the sum of the following elements:

- a. Instruments issued by the licensed person that meet the criteria for inclusion in Additional Tier 1 capital outlined in the Article 3-11 (and not included in Common Equity Tier 1).
- b. Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital.

Article 3-11

**B.2.A Financial Instruments issued by the licensed person meeting the criteria of inclusion in Additional Tier 1 Capital**

The following list sets out the minimum set of criteria for an instrument issued by the licensed person in order for it to be included in Additional Tier 1 capital:

- a. Issued and paid-in.
- b. Subordinated to depositors, general creditors and subordinated debt of the licensed person.
- c. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis creditors.
- d. Is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.
- e. May be callable at the initiative of the issuer only after a minimum of five years:
  - i. To exercise a call option and redeem, the issuing licensed person must receive prior CMA approval.
  - ii. A licensed person must not do anything which creates an expectation that the call will be exercised.
  - iii. Licensed persons must not exercise a call unless:
    - a. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the licensed person.
    - b. The licensed person demonstrates that its capital position is well above the total applicable capital requirements after the call option is exercised.
- f. Any repayment of principal must be with prior CMA approval and licensed persons should not assume or create market expectations that CMA approval will necessarily be given.
- g. Dividend/coupon discretion:
  - i. the licensed person must have full discretion at all times to cancel distributions/payments.
  - ii. cancellation of discretionary payments must not be an event of default.
  - iii. licensed persons must have full access to cancelled payments to meet obligations as they fall due.
  - iv. the cancellation of distributions/payments must not impose restrictions on the licensed person except in relation to distributions to common stockholders.
- h. Dividends/coupons must be paid out of distributable items.
  - i. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is dependent in whole or in part on the licensed person's credit standing (i.e. dividend distributions cannot be adjusted in case the credit rating of the licensed person or its group is downgraded).
- j. In case of liquidation, these instruments are not considered liabilities if considering them as such results in liabilities exceeding assets while taking into consideration the applicable laws.

- k. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either:
  - i. conversion to common shares at an objective pre-specified trigger point.
  - ii. a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:
    - a. Reduce the claim of the instrument in liquidation.
    - b. Reduce the amount repaid when a call is exercised.
    - c. Partially or fully reduce coupon/dividend payments on the instrument.
- l. Neither the licensed person nor a related party over which the licensed person exercises control or significant influence can have purchased the instrument, nor can the licensed person directly or indirectly have funded the purchase of the instrument.
- m. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
- n. If the instrument is issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle - "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

**B.2.B Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital**

**Article 3-12**

Stock surplus (i.e. share premium) that is not eligible for inclusion in Common Equity Tier 1, will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 capital as provided for in article (3-11).

**B.3 Tier 2 Capital**

**Article 3-13**

Tier 2 capital consists of the sum of the following elements:

- a. Instruments issued by the licensed person that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital).
- b. Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital.

Article 3-14

**B.3.A Instruments issued by the licensed person that meets the Tier 2 criteria**

Criteria for inclusion in Tier 2 Capital:

- a. Issued and paid-in.
- b. Subordinated to depositors and general creditors of the licensed person.
- c. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general creditors.
- d. Maturity:
  - i. minimum original maturity of at least five years.
  - ii. recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis.
  - iii. there are no step-ups or other incentives to redeem.
- e. May be callable at the initiative of the issuer only after a minimum of five years:
  - i. To exercise a call option a licensed person must receive prior CMA approval.
  - ii. A licensed person must not do anything that creates an expectation that the call will be exercised.
  - iii. Licensed persons must not exercise a call unless:
    - a. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the licensed person.
    - b. The licensed person demonstrates that its capital position is well above the total applicable capital requirements (i.e. Risk Charges) after the call option is exercised.
- f. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
- g. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is dependent in whole or in part on the licensed person's credit standing. (i.e. dividend distributions cannot be adjusted in case the credit rating of the licensed person or its group is downgraded).
- h. Neither the licensed person nor a related party over which the licensed person exercises control or significant influence can have purchased the instrument, nor can the licensed person directly or indirectly have funded the purchase of the instrument.
- i. If the instrument is issued out of an operating entity or the holding company in the consolidated group (e.g. an SPV), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

**B.3.B Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital**

**Article 3-15**

Stock surplus (i.e. share premium) that is not eligible for inclusion in CET1 or AT1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 capital as provided for in article (3-14).

**B.4 Minimum loss absorbency requirements at the point of non-viability**

**Article 3-16**

The terms and conditions of all non-common stock CET1, AT1 and Tier 2 instruments issued by a licensed person must have a provision that requires such instruments, at the option of the CMA, to either be written off or converted into common equity upon the occurrence of the trigger event as defined in Article 3-18.

**Article 3-17**

Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock, subject to laws, bylaws, and resolutions issued in this regard by the relevant parties. The issuing licensed person must also maintain at all times all prior authorisation and mandates necessary to immediately issue the relevant number of shares should the trigger event occur.

**B.4.A Trigger event (write-off or conversion)**

**Article 3-18**

The trigger event is the earlier of:

- a. a decision that a write-off, without which the licensed person would become non-viable, is necessary, as determined by the CMA; and
- b. the decision to make a public-sector injection of capital, or equivalent support, without which the licensed person would have become non-viable.

**Article 3-19**

The issuance of any new shares as a result of the trigger event must occur prior to any injection of capital.

**B.5 Minority interest and other capital issued out of consolidated subsidiaries**

**Article 3-20**

Minority interest arising from the issue of CET 1, AT1 or T2 capital instruments issued by a fully consolidated subsidiary of a licensed person may receive recognition as CET 1, AT1 or T2 capital respectively, of the licensed person only if:

- a. the instrument giving rise to the minority interest would, if issued by the licensed person, meet all of the criteria for classification as CET1, AT1 or T2 capital respectively; and,
- b. the subsidiary that issued the instrument is itself a licensed person, or an existing Collective Investment Scheme (CIS) licensed by the CMA.

## B.6 Deductions and Regulatory adjustments

### B.6.A Proposed dividends

**Article 3-21** Dividends (proposed but not incurred by the Licensed person) are removed from CET1 capital of Licensed person in accordance with applicable accounting standards.

### B.6.B Goodwill and other intangibles

**Article 3-22** Licensed person must deduct Goodwill and all other intangibles in the calculation of CET 1 including any goodwill included in the valuation of investments in associate companies with significant equity, including financial institutions that are outside the scope of regulatory consolidation. The full amount is to be deducted net of any associated deferred tax liability, which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards implemented in the state of Kuwait.

**Article 3-23** Licensed persons should use the IFRS definition of intangible assets to determine which assets are classified as intangible and are thus required to be deducted.

### B.6.C Investments in own shares

**Article 3-24** All of a licensed person's investments in its own common shares, whether held directly or indirectly, will be deducted in the calculation of CET 1 capital (unless already derecognised under the relevant accounting standards implemented in the state of Kuwait). In addition, any own stock which the licensed person could be contractually obliged to purchase should be deducted in the calculation of CET1 capital. In addition:

- a. Gross long positions may be deducted net of short positions in the same underlying exposure, only if the short positions involve no counterparty risk.
- b. Licensed persons should look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short position in own shares resulting from short positions in the same underlying index. In such cases the short positions may involve counterparty risk (which will be subject to the relevant counterparty credit risk charge).

**Article 3-25** This deduction is necessary to avoid the double counting of a licensed person's own capital. The treatment seeks to remove the double counting that arises from direct holdings, indirect holdings via index funds and potential future holdings as a result of contractual obligations to purchase own shares.



**B.6.D Reciprocal cross holdings in the capital of other financial entities**

**Article 3-26**

Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of licensed persons will be deducted in full from CET1. Licensed persons must apply a deduction to such investments in the capital of other financial entities.

**B.6.E Investment in the capital of financial entities**

**Article 3-27**

The regulatory adjustment described in this section applies to investments in the capital of financial entities that are outside the scope of regulatory consolidation. In addition:

- a. These investments are classified in accordance with IFRS 9, or classified as investments in associates/joint ventures in accordance with International Accounting Standard 28 (IAS 28).
- b. These investment (i.e. Capital) includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt where the investment in the capital instrument is a loan or security that ranks below other loans or securities with regard to claims on assets or earnings). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).
- c. Positions held for five working days or less can be excluded. Positions held for longer than five working days must be included.
- d. At CMA's discretion licensed persons may exclude temporarily, with prior supervisory approval, certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

**Article 3-28**

A licensed person must deduct the amount by which the aggregate of all investments in unconsolidated financial entities as listed in article (3-27) exceeds 10% of its CET1 (calculated after application of all other regulatory adjustments/deductions applied in the calculation of CET1).

**Article 3-29**

Amounts below the 10% threshold that are not deducted are subject to capital charge of 37.5% and these exposures should not be included in any other capital charge calculations (i.e. to be excluded from the treatment described in articles 4-27 to 4-31 and articles 4-59 to 4-62).

## Chapter Four

### Risk Based Capital Charges

4

#### A. Market Risk

##### A.1 General requirements

**Article 4-1** Market risk is defined as the risk of losses arising from movements in market prices.

**Article 4-2** This section describes the risk charge rules that licensed persons need to adopt to calculate the appropriate capital requirements for their market risk exposure.

##### A.2 Types of market risk exposures

**Article 4-3** Market risk exposures arise from positions held in financial instruments with the intent of benefiting from actual or expected price movements or to lock in arbitrage profits. These positions may include proprietary positions, positions arising from client servicing and market making. Market risk exposures will include all financial instruments that are classified as FVTPL as per IFRS 9 classification.

**Article 4-4** A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both, primary financial instruments (or cash instruments) and derivative financial instruments.

##### A.3 Scope and coverage of capital charges for market risk

**Article 4-5** The capital charges for market risk shall be calculated for the following:

- a. Interest rate position risk  
Applicable to all interest rate sensitive positions in the Balance Sheet, notwithstanding IFRS 9 classification of underlying instruments as FVTPL or otherwise.
- b. Equity position risk  
All equity positions classified as FVTPL under IFRS 9 (excluding equity options which are covered under Options risk).
- c. Foreign exchange risk  
Applicable to Net Open Position in FX and gold of the entire consolidated business of the licensed person.
- d. Commodities risk.
- e. Options risk.

#### A.4 Calculation of capital charges for market risk

- Article 4-6** Market risk capital charge is determined separately for Specific Risk and General Risk where applicable.
- Article 4-7** Specific risk is defined as the risk of loss caused by an adverse price movement of security principally due to factors related to the issuer.
- Article 4-8** General market risk is defined as the risk of loss arising from adverse changes in market prices.
- Article 4-9** The capital charge for market risk is the sum of capital required to cover the following risks multiplied by an overall factor of 1.875:
- a. Interest rate risk.
  - b. Equity position risk.
  - c. Foreign exchange risk.
  - d. Commodities risk.
  - e. Options risk.

##### A.4.A. Interest Rate Risk

- Article 4-10** The capital requirement for interest rate risk should be calculated for all interest rate positions held (all assets and liabilities instruments regardless of their IFRS 9 classification). The instruments covered by interest rate position risk include, but are not limited to, the following:
- a. Bonds
  - b. Debentures
  - c. Certificates of deposits
  - d. Treasury bills
  - e. Floating rate notes
  - f. Derivatives
- Article 4-11** The minimum capital requirement is expressed in terms of two separately calculated charges, one applying to the Specific risk of each security, whether it is a short or a long position, and the other to the interest rate risk in the portfolio (termed general market risk) where long and short positions in different securities or instruments can be offset.
- Article 4-12** The capital charge for interest rate risk is the sum of the capital required for specific risk and general risk.

**A.4.A.i. Specific Risk**

**Article 4-13**

The specific risk charge applies to all on-and off-balance sheet interest rate positions.

**Article 4-14**

In measuring specific risk charge, long and short positions can be netted for positions in identical issues. Instruments will be considered identical where the issuer is the same, have equivalent rank in liquidation and the currency, coupon and maturity are the same.

**Article 4-15**

The specific risk charge for on-balance sheet interest rate positions (issuer risk), whether long or short, is calculated by multiplying the market value of the debt positions by the specific risk charges in table below that correspond to the category and residual term of the debt instrument.

Table 1: Specific risk charge for on-balance sheet interest rate risk positions

Category of Debt Instruments	Credit Quality Grades	Residual Term to Maturity	Risk Charge (%)
i) Government Debt instruments	1, including those denominated and funded in the domestic currency	N/A	0.00
	2 and 3	6 months or less	0.25
		Over 6 to 24 months	1.00
		Over 24 months	1.60
	4,5 and 6	N/A	12.00
ii) Fully Guaranteed Debt Instruments issued by Public Sector Enterprises (Qualifying)	6 months or less	0.25	
	Over 6 to 24 months	1.00	
	Over 24 months	1.60	
iii) Other Debt instruments and any unrated instruments		N/A	12.00
Note: In respect of the above table and all other tables set out in these regulations, the period of one month should be regarded as comprising of 30 days			

- Article 4-16** Government debt instruments include all forms of debt instruments, including but not limited to bonds, treasury bills and other short-term instruments issued by, fully guaranteed by, or fully collateralised by central governments of the OECD-based group of countries, and GCC countries whose debts are, by virtue of their enabling legislation, direct obligations of the parent government.
- Article 4-17** Fully guaranteed debt instruments issued by public sector institutions (qualifying) include debt securities:
- Issued by, or fully guaranteed by GCC public sector entities or OECD or treated as sovereign, including Kuwaiti public sector entities.
  - Issued by, or fully guaranteed by, Kuwaiti bank or GCC bank or OECD or where the instrument does not qualify as capital of the issuing bank.
  - Rated investment-grade by any ECAs.
- Article 4-18** The specific risk charge for derivative contracts is calculated by multiplying the market value of the effective notional amount of the debt instrument that underlies an interest rate swap, future or forward by the specific risk charges in Table 1 above that correspond to the category and residual term of the underlying debt instrument.
- A.4.A.ii. General Market Risk**
- Article 4-19** The general market risk applies to all on-and off-balance sheet interest rate positions. This includes a net charge for positions in options, wherever licensed persons use the delta-plus approach for options.

**Article 4-20**

The general market risk charge should be calculated as follows:

- a. First distribute the long or short position (at current market value) of each debt instrument and other source of interest rate exposure, including derivatives, into the time bands of the maturity ladder outlined in Table 2 below.
- b. A separate maturity ladder must be constructed for each currency in which a licensed person has significant positions (KD 30,000 or more), and capital requirements must be calculated for each currency separately. Offsetting of positions shall not be permitted between different currencies in which positions are significant (KD 30,000 or more).
- c. Positions in currencies that are not significant (less than KD 30,000) may be combined into a common maturity ladder, with the net long or short position of each currency entered in the applicable time band.
- d. Opposite positions of the same amount in the same issues (but not different issues by the same issuer), whether actual or notional, may be excluded from the interest rate maturity framework. Licensed persons may also exclude closely matched swaps, forwards, futures and forward rate agreements (FRAs) that meet the conditions set out in Articles 4-25 and 4-26.
- e. Fixed rate instruments should be allocated according to the residual term to maturity and floating-rate instruments according to the residual term to the next re-pricing date. Once all long and short positions are placed into the appropriate re-pricing time-bands, the long and short positions in each time-band are summed. The summed positions are multiplied by the appropriate risk charge factor (reflecting price sensitivity of the positions to changes in interest rates) to determine the risk-charge figures which are summed to give capital requirement for general market risk. An illustration is provided in Appendix 4 (Example 2).

Table 2: Time-bands and Charge (%)

Time-bands	Risk Charge (%)
up to 1 month	0.00
Over 1 up to 3 months	0.20
Over 3 up to 6 months	0.40
Over 6 months up to 1 year	0.70
Over 1 up to 1.9 years	1.25
Over 1.9 up to 2.8 years	1.75
Over 2.8 up to 3.6 years	2.25
Over 3.6 up to 4.3 years	2.75
Over 4.3 up to 5.7 years	3.25
Over 5.7 up to 7.3 years	3.75
Over 7.3 up to 9.3 years	4.50
Over 9.3 up to 10.6 years	5.25
Over 10.6 up to 12 years	6.00
Over 12 up to 20 years	8.00
Over 20 years	12.50

#### A.4.A.iii. Interest Rate Derivatives

- Article 4-21** Risk-based capital charges shall be measured for all interest rate derivatives and off-balance sheet instruments which react to changes in interest rates, (e.g. forward rate agreements (FRAs), other forward contracts, bond futures, interest rate and cross-currency swaps and forward foreign exchange positions). Treatment of interest rate options is covered under Options Risk section from articles 4-43 to 4-55.
- Article 4-22** The derivatives should be converted into positions in the relevant underlying and become subject to specific and general market risk charges as described above. In order to calculate the charges described above, the amounts reported should be the market value of the principal amount of the underlying or of the notional underlying.
- Article 4-23** These instruments are treated as a combination of a long and a short position in a notional government security. The maturity of a future or a FRA will be the period until delivery or exercise of the contract, plus - where applicable - the life of the underlying instrument. For example, a long position in a June three month interest rate future (taken in April) is to be reported as a long position in a government security with a maturity of five months and a short position in a government security with a maturity of two months. Where a range of deliverable instruments may be delivered to fulfil the contract, the licensed person has flexibility to elect which deliverable security goes into the maturity ladder but should take account of any conversion factor defined by the exchange. In the case of a future on a corporate bond index, positions will be included at the market value of the notional underlying portfolio of securities.
- Article 4-24** Swaps will be treated as two notional positions in government securities with relevant maturities. For example, an interest rate swap under which a licensed person is receiving floating rate interest and paying fixed will be treated as a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed-rate instrument of maturity equivalent to the residual life of the swap. For swaps that pay or receive a fixed or floating interest rate against some other reference price, e.g. a stock index, the risk-based capital charges for the interest rate component should be measured by slotting the interest rate into the appropriate re-pricing maturity category, and the risk-based capital charge for the equity component should be measured in accordance with section (a.4.b) below. The separate legs of cross-currency swaps are to be reported in the relevant maturity ladders for the currencies concerned.

**Article 4-25**

Licensed persons may exclude from the interest rate maturity framework altogether (for both specific and general market risk) long and short positions (both actual and notional) in identical instruments with exactly the same issuer, coupon, currency and maturity. A matched position in a future or forward and its corresponding underlying may also be fully offset, and thus excluded from the calculation. When the future or the forward comprises a range of deliverable instruments offsetting of positions in the future or forward contract and its underlying is only permissible in cases where there is a readily identifiable underlying security which is most profitable for the licensed person with a short position to deliver. The price of this security, sometimes called the “cheapest-to-deliver”, and the price of the future or forward contract should in such cases move in close alignment. No offsetting will be allowed between positions in different currencies; the separate legs of cross-currency swaps or forward foreign exchange deals are to be treated as notional positions in the relevant instruments and included in the appropriate calculation for each currency.

**Article 4-26**

In addition, opposite positions in the same category of instruments can in certain circumstances be regarded as matched and allowed to offset fully. To qualify for this treatment the positions must relate to the same underlying instruments, be of the same nominal value and be denominated in the same currency. In addition:

- a. For futures: offsetting positions in the notional or underlying instruments to which the futures contract relates must be for identical products and mature within seven days of each other.
- b. For swaps and FRAs: the reference rate (for floating rate positions) must be identical and the coupon closely matched (i.e. within 15 basis points).
- c. For swaps, FRAs and forwards: the next interest fixing date or, for fixed coupon positions or forwards, the residual maturity must correspond within the following limits:
  - i. Less than one month hence: same day.
  - ii. Between one month and one year hence: within seven days.
  - iii. Over one year hence: within thirty days.



#### A.4.B. Equity Position Risk

##### Article 4-27

The capital requirement for equities risk applies to all equity positions classified as FVTPL excluding the following:

1. Options.
2. Positions that are investment in unconsolidated financial entities already subject to deduction as per article 3-28 or 37.5% capital charge as per article 3-29.
3. Positions that represent investments in investment funds, which are subject to the 30% capital charge as per article (4-61 b).
4. Positions that represent investments in venture capital or private equity investments, which are subject to the 60% capital charge as per article (4-60 b).

The instruments covered include, but are not limited to the following:

- a. Ordinary shares.
- b. Convertible securities that behave like equities.
- c. Depository receipts (these should be converted into the underlying shares and allocated to the same country as the underlying shares).
- d. Any other instruments exhibiting equity characteristics or which the licensed person believes carries equity risk.
- e. Equity derivatives or derivatives based on above securities.

##### Article 4-28

In order to compute capital charge for equities risk, equity positions should first be allocated to the country in which each equity is located. Where an equity is located in more than one country, one country should be chosen and used consistently. Conversion into Kuwaiti Dinars should be done at spot foreign exchange rates using mid-market prices.

##### Article 4-29

The capital charge for equities risk is the sum of the following:

- a. A Specific Risk charge of 8% of the gross position (i.e. sum of the absolute value of all short equity positions and all long equity positions, including derivatives), calculated for each country.
- b. General Risk charge of 8% of the net equity position, calculated for each country.

##### Article 4-30

Matched positions in each identical equity or stock index in each country may be fully offset, resulting in a single net short or long position to which the specific and general market risk charges will apply.

##### Article 4-31

If a licensed person takes a position in depository receipts against an opposite position in the underlying equity or identical equities in different markets, it may offset the position (i.e. bear no capital charge) but only on condition that any costs on conversion are fully taken into account.

#### A.4.C Foreign Exchange Risk

- Article 4-32** The capital requirement for foreign exchange risk applies to foreign exchange risk of the entire business, i.e. entire Net Open Position (including gold).
- Article 4-33** In order to calculate the capital charge for foreign exchange risk, the net position in each foreign currency and gold should be converted into Kuwait Dinars at spot rates using mid-market prices.
- Article 4-34** The capital charge for foreign exchange risk is 8% of the sum of the following:
- The greater of the sum of the net open short positions or the sum of the net open long positions (absolute values).
  - The net open position in gold, either long or short, regardless of sign.
- Article 4-35** The net open position in each foreign currency and gold should be the total of:
- The net spot position (i.e. all asset items less all liability items, including accrued interest and accrued expenses, denominated in the relevant currency).
  - The net forward position (i.e. all net amounts under forward, future agreements and foreign exchange transactions, including currency futures and the principal on currency swaps not included in the spot position).
  - Guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable.
  - Net future income/expenses not yet accrued but already fully hedged.
  - The net delta-based equivalent of the total book of foreign currency options. An illustration is provided in Appendix 4 (Example 3)
- Article 4-36** All positions - spot and forward, should be valued at spot market exchange rates using mid-market prices.
- Article 4-37** Interest accrued (i.e. earned but not yet received) should be included as a position. Accrued expenses should also be included. Unearned but expected future interest and anticipated expenses may be excluded.
- Article 4-38** Forward currency and gold positions will normally be valued at current spot market exchange rates. Using forward exchange rates would be inappropriate since it would result in the measured positions reflecting current interest rate differentials to some extent. However, licensed persons which base their normal management accounting on net present values are expected to use the net present values of each position, discounted using current interest rates and valued at current spot rates, for measuring their forward currency and gold positions.
- Article 4-39** Structural positions (i.e. non-dealing positions such as investment in subsidiaries, associates) may be exempt on a case to case basis at the discretion of CMA.

#### A.4.D. Commodities Risk

**Article 4-40** The capital requirement for commodities risk covers the market risk of holding or taking positions in commodities, including precious metals (excluding gold) and commodity options. The capital requirement applies to the commodities risk of the entire business.

**Article 4-41** A commodity is defined as a physical product which is or can be traded on a secondary market, e.g. agricultural products, minerals (including oil) and precious metals (excluding gold).

**Article 4-42** The capital charge for commodity risk should be calculated as follows:

- a. First each long and short commodity position (spot and forward) should be expressed in terms of the standard unit of measurement (such as barrels, kilos or grams). The open position in each commodity should then be converted at spot rates into Kuwait Dinars, and the long and short positions should be offset to arrive at the net open position in each commodity.
- b. Positions in different commodities should not be offset.
- c. Commodity derivatives should be converted into notional commodity positions using the mid-market spot price. This includes commodity futures, commodity swaps, and options.
- d. The capital charge for commodities risk is the sum of:
  - i. 15% of net open position in each commodity.
  - ii. 3% of gross position (long position plus absolute value of short position).

An illustration is provided in Appendix 4 (Example 4)

#### **A.4.E. Options Risk**

**Article 4-43** The capital requirement for options applies to option contracts and related hedging positions in the associated underlying instrument, commodity or index, cash or forward.

**Article 4-44** In calculating capital requirement for options, licensed persons which solely use purchased options can use Simplified Method described in articles 4-46 to 4-50.

**Article 4-45** Licensed persons that 'write' options must use Delta-Plus method described in the articles 4-51 to 4-55.

**A.4.E.i Simplified Method for Options Risk**

**Article 4-46**

The capital charge for options risk under simplified method should be computed as set out in the table below.

Table 3: Options risk capital charge

Position	Treatment
Long the underlying and Long the Put or Short the underlying and Long the Call	The capital charge will be: The market value of the underlying instrument multiplied by the sum of specific and general market risk charges for the underlying less the amount the option is in the money (if any) bounded at zero
Long call or Long put	The capital charge will be lesser value of: a. The market value of the underlying instrument multiplied by the sum of specific and general market risk charges for the underlying b. The market value of the option.

An illustration is provided in Appendix 4 (Example 5)

**Article 4-47**

In some cases, such as foreign exchange it may be unclear which side is the “underlying instrument”; this should be taken to be the asset which would be received if the option were exercised. In addition, the nominal value should be used for items where the market value of the underlying instrument could be zero, e.g. caps and floors.

**Article 4-48**

To determine the appropriate specific risk and general market risk charges, refer back to the preceding articles on interest rate positions risk, equity position risk, foreign exchange risk and commodity risk. Some options (e.g. where the underlying is an interest rate, a currency or a commodity) bear no specific risk but specific risk will be present in the case of option on certain interest rate relating instruments (e.g. options on a corporate debt security or corporate bond index) and for options on equities and stock indices. Accordingly, the combined charge under this measure for currency options will be 8% and for options on commodities 15%.

**Article 4-49**

In the money means the exercise level of a:

- a. “Call option” is less than the current mark-to-the-market value of the underlying instrument.
- b. “Put option” is that the current mark-to-market-value of the underlying instrument is less than the exercise level of the put option.

**Article 4-50**

For options with a residual maturity of more than six months the strike price should be compared with the forward, not current price. A licensed person unable to do this must take in the money amount to be zero.

#### A.4.E.ii Delta-plus method

- Article 4-51** The delta-plus method uses the sensitivity parameters associated with options to measure their market risk and capital requirements. Under this method, the delta-equivalent position of each option becomes part of the market risk calculation set out in articles 4-1 to 4-42 with the delta-equivalent amount subject to the applicable general market risk charges.
- Article 4-52** Licensed persons which write options will be allowed to include delta-weighted options positions within the calculation set out in articles 4-1 to 4-42. Such options should be reported as a position equal to the market value of the underlying multiplied by the delta. However, since delta does not sufficiently cover the risks associated with options positions, licensed persons will also be required to measure gamma (which measures the rate of change of delta) and Vega (which measures the sensitivity of the value of an option with respect to a change in volatility) sensitivities in order to calculate the total capital charge.
- Article 4-53** Delta-weighted positions with debt securities or interest rates as the underlying will be slotted into the interest rate time-bands, as set out in articles 4-10 to 4-26, under the following procedure. A two-legged approach should be used as for other derivatives, requiring one entry at the time the underlying contract takes effect and a second at the time the underlying contract matures. For instance, a bought call option on a June three-month interest-rate future will in April be considered, on the basis of its delta-equivalent value, to be a long position with a maturity of five months and a short position with a maturity of two months. The written option will be similarly slotted as a long position with a maturity of two months and a short position with a maturity of five months. Floating rate instruments with caps or floors will be treated as a combination of floating rate securities and a series of European-style options. For example, the holder of a three-year floating rate bond indexed to six-month LIBOR with a cap of 15% will treat it as:
- a. A debt security that re-prices in six months.
  - b. A series of five written call options on a FRA with a reference rate of 15%, each with a negative sign at the time the underlying FRA takes effect and a positive sign at the time the underlying FRA matures.
- Article 4-54** The capital charge for options with equities as the underlying will also be based on the delta-weighted positions which will be incorporated in the measure of market risk described in articles 4-27 to 4-31. For purposes of this calculation each national market is to be treated as a separate underlying.
- Article 4-55** The capital charge for options on foreign exchange and gold positions will be based on the method set out in articles 4-32 to 4-39. For delta risk, the net delta-based equivalent of the foreign currency and gold options will be incorporated into the measurement of the exposure for the respective currency (or gold) position. The capital charge for options on commodities will be based on the simplified approach set out in articles 4-40 to 4-42. The delta-weighted positions will be incorporated in one of the measures described in that section.

**B. Operational Risk**

**Article 4-56**

Operational Risk refers to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

**Article 4-57**

A licensed person should have documented criteria for mapping gross income for current business lines and activities and calculate capital charge for Operational Risk as prescribed below:

- a. Calculate the Operational Risk Capital Charge for each of the business lines as annual gross income multiplied by a fixed percentage, called a “beta”.
- b. The total capital charge is calculated as the product of multiplier (1.875) to the three-year average of the simple summation of the capital charges across each of the business lines in each year. In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the numerator for that year will be zero. Operational Risk Capital Charge may be expressed by the following formula:

$$\text{Capital Charge} = 1.875 * \{ \sum_{\text{years 1-3}} \max[ \sum (\text{GI}_{\text{business line}} \times \text{Beta}_{\text{business line}}), 0 ] \} / 3$$

where:

GI = annual gross income in a given year for each of the business lines

Beta = a fixed percentage, termed a “beta factor”, for each business line

- c. Capital Charge must be computed using the following beta factors:

Business Line	Beta Factor
Brokerage	24%
Trading/Investment	18%
Investment Portfolio / CIS Management & Managing any Client Asset	12%
Providing Financing	15%
Payment and settlement, Clearing and Market Making	18%
Custodian	15%
All Other	24%

**Article 4-58** If a licensed person is unable to map its Gross Income to its current business lines and activities as required above, then with prior CMA approval, the licensed person may calculate total operational risk capital charge as 24% of the summation of the three-year average gross income multiplied by a factor of 1.875. In case of a licensed person with negative gross income for the previous three years, a newly licensed person with less than 3 years of operations, or a merger, acquisition or material restructuring, the CMA may, at its discretion, allow use of the projected gross income in the licensed person's 3-year business plan.

An illustration is provided in Appendix 4 (Example 6)

### C. Investment risk

**Article 4-59** Investments in Equity of Financial Institutions that are outside the scope of regulatory consolidation and not deducted from capital as per article (3-28) will be subject to a capital charge of 37.5% as described in article (3-29).

**Article 4-60**

- a. Except for the investments mentioned in item (b) of this article, equity investments classified as FVOCI as per IFRS 9, or classified as investment in associates/joint venture as per IAS 28, are subject to a 15% charge.
- b. Investments in the following equity are subject to a 60% capital charge, and will be reported under "High-Risk Exposures" Category:
  - Unlisted equity investments classified as investments in associates/joint ventures as per IAS 28
  - Venture capital or private equity investments.
- c. The CMA has the right to require licensed persons to calculate the capital charge for investment risk at a rate of 60% on investments that the CMA deems to be high in risk.

**Article 4-61** Treatment of Investment in Funds (outside the scope of consolidation)

- a. If the licensed person can distinguish individual components (e.g. equity, bonds) that constitute the fund, then investment in funds is treated as direct investments in those components and capital charge is calculated as per treatment for each individual component.
- b. If the licensed person is unable to distinguish individual components that constitute the fund, then the entire investment in the investment funds is subject to a 30% capital charge.

**Article 4-62** Investments in Real Estate are subject to a 30% capital charge.

## D. Credit Risk

### D.1 On-balance Sheet Exposures

#### D.1.A General Requirements

#### Article 4-63

This section sets out the guidelines to be adopted by licensed persons to quantify their credit risk capital charge. More specific capital charge for Derivatives and Securities Financing transactions will be covered in separate sections. Refer to articles 4-168 to 4-179.

The section outlines detailed guidelines for credit risk charge calculation to provide complete coverage of a wider range of counterparties products and credit risk mitigation options (e.g. collateral), where relevant and applicable to the exposures of a licensed person subject to risk based capital requirements.

#### Article 4-64

Different categories of on- and off-balance sheet exposures of a licensed person are to be subject to risk charges, according to type of client, exposure and the ratings assigned by external credit assessment institutions (ECAIs), where available.

#### Article 4-65

The requirements set out in this section apply to all credit exposures of a licensed person that are not classified as FVTPL as per IFRS 9 (FVTPL exposures are subject to Market Risk treatment).

#### D.1.B Exposure Types and Risk charges

#### Article 4-66

Credit exposures should be categorized into the following portfolios:

- a. Sovereigns
- b. Public sector entities (PSEs)
- c. Banks
- d. Corporates
- e. Central counterparties
- f. Cash items

Any credit exposure that does not fall into any of the above categories (for example credit exposure to individuals) will be classified under a separate called other exposures and will attract a risk charge of 15%.

#### Article 4-67

These standard portfolios are mutually exclusive and therefore any given exposure should be categorised under only one of them. The credit risk of any exposure for which a licensed person has to set aside regulatory capital is measured in terms of the risk charge of the exposure.

#### Article 4-68

Licensed persons may use Credit Risk Mitigation (CRM) techniques to reduce their credit risk exposures. Detailed list of CRMs, the criteria for their recognition and the extent to which each of these techniques can reduce the capital requirement of a credit exposure are discussed in detail within articles 4-94 to 4-127 below.



**Article 4-69** The risk charge is calculated by multiplying the outstanding exposure, net of specific provisions, if any, with the applicable risk charge. For an exposure covered by eligible CRM techniques, the risk charge of the exposure can be reduced based on the treatment described in the Credit Risk Mitigation section (D.3) below.

**Article 4-70** In order to avoid any double counting of credit enhancement factors, no supervisory recognition of credit risk mitigation (CRM) techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on exposures for which an issue-specific rating is used that already reflects that CRM.

**D.1.C Risk charge for individual on-balance sheet exposures**

**Article 4-71** The portfolios listed between Articles 4-73 to 4-85 should be subject to risk charge based on their Credit Quality Grades (see Appendix 1).

**Article 4-72** However, credit facilities granted by licensed persons to finance trading in real estate and trading in securities, should have a risk charge of 22.5% (notwithstanding the borrower’s credit rating).

**D.1.C.i Exposure to Sovereigns**

**Article 4-73** Any exposure to Kuwait sovereign should be subject to risk charge of 0%.

**Article 4-74** Exposure to other sovereigns (including GCC countries) should be subject to risk charge based on the following sovereign credit quality grades:

Table 4: Exposure to Sovereigns

Sovereign Credit Quality Grades	1	2	3	4	5	6	Unrated
Risk charge	0%	3%	7.5%	15%	15%	22.5%	15%

**D.1.C.ii Exposure to Public Sector Entities (PSEs)**

- Article 4-75** Exposure to Kuwaiti PSEs in Kuwaiti Dinar should be treated as exposure to the Kuwaiti sovereign and subject to risk charge of 0%.
- Article 4-76** Exposure to Kuwait PSEs in non-Kuwaiti dinar currencies should be subject to a risk charge of 3%, unless these are supported by an unconditional, irrevocable and continuing guarantee provided by the Kuwaiti Government, in which case a 0% risk charge will apply.
- Article 4-77** Domestic currency exposure to other GCC PSEs should be treated as exposure to their sovereigns if their central bank or monetary authority treats it as such. Foreign currency exposure to such PSEs should be subject to risk charge one grade less favourable than its sovereign.
- Article 4-78** Exposure to other foreign PSEs should be subject to risk charge one grade less favourable than its sovereign.
- Article 4-79** Exposure to commercial companies owned by PSEs shall be treated as exposure to corporates and assigned risk charges based on the corporate credit quality grade as specified in articles 4-82 to 4-85 related to Exposure to Corporates.

**D.1.C.iii Exposure to Banks**

- Article 4-80** Exposure to Kuwaiti banks, including their overseas branches, should be assigned a risk charge one grade less favourable than that assigned to Exposure to the Kuwaiti Government, i.e. applying a risk charge of 3%.
- Article 4-81** Exposure to foreign banks outside Kuwait including Kuwaiti banks' overseas banking subsidiaries, should be subject to risk charge based on the bank's credit quality grades, if available. No claim on an unrated bank may receive a risk charge better than that applied to exposure to its sovereign of incorporation.

Table 5: Exposure to Banks

Bank's Credit Quality Grades	1	2	3	4	5	6	Unrated
Risk charge	3%	7.5%	7.5%	15%	15%	22.5%	7.5%

**D.1.C.iv Exposure to Corporates**

**Article 4-82**

Exposure to corporates should be subject to risk charge as follows:

Table 6: Exposure to Corporates

Corporate's Credit Quality Grades	1	2	3	4	5	6	Unrated
Risk charge	3%	7.5%	15%	15%	22.5%	22.5%	15%

**Article 4-83**

No claim on an unrated corporate should be given a risk charge lower than that assigned to its sovereign of incorporation.

**Article 4-84**

Exposure to Financial Institutions other than banks, including Securities and Investment Firms, should be subject to risk charge as exposure to corporates.

**Article 4-85**

The Capital Markets Authority may increase the above standard risk charge for unrated exposures where it judges that a higher risk charge is warranted by the overall default experience in Kuwait.

**D.1.C.v Exposure to Central Counterparties**

**Article 4-86**

Exposure to central counterparties will be treated as per details provided under articles 4-151 to 4-167 of these Guidelines (i.e. module).

**D.1.C.vi Cash Items**

**Article 4-87**

The following types of asset are regarded as cash items which should attract a 0% risk charge (other than the 5th item below):

- a. Notes and coins.
- b. All gold bullion held in the vaults of banks or other financial institution.
- c. Cheques, drafts and other items drawn on other licensed persons that are payable immediately upon presentation and that are in the process of collection.
- d. All receivable funds arising from the sale of securities, for the licensed person's own account or on behalf of a customer, which are outstanding up to and including the fifth working day after the due settlement date.
- e. All receivable funds arising from the purchase of securities on behalf of a customer, which are outstanding up to and including the fifth working day after the due settlement date, which will attract a 3% risk charge.

## D.2 Off-balance Sheet Credit Exposures

### Article 4-88

This section sets out the treatment of off-balance sheet items and their applicable conversion factors for contingent items for the purpose of determining the risk charge. These off-balance sheet exposures are related and limited to instruments that give rise to credit exposures which are outlined in article 4-92. The categorization for these off-balance sheet credit exposures will be in line with categorization for on balance sheet credit exposures in article 4-66.

### D.2.A Risk Charge Calculation

### Article 4-89

For each off-balance sheet exposure, other than derivatives and AUM, the risk charge is calculated based on the Credit Equivalent Amount of the exposure, which is determined by applying a percentage to those obligations that will vary according to the nature of the obligation. Such a percentage is known as the Credit Conversion Factor (CCF).

### Article 4-90

The Credit Equivalent Amount is then multiplied by the applicable risk charge of the original exposure in the same way as in on-balance sheet exposures to arrive at the risk charge for the exposure.

### Article 4-91

For exposures covered by eligible CRM techniques, the risk charge can be reduced based on the treatments described in the Credit Risk Mitigation section (D.3) below.

**D.2.B Credit conversion factors**

**Article 4-92**

The following list gives the CCFs for individual types of off-balance sheet exposures, other than derivatives and AUM, where applicable:

Table 7: CCF for off-balance sheet exposures other than derivatives and AUM

Particulars	CCF
<p><b>Commitments</b> representing the undrawn portion of any binding arrangements with an original maturity of up to one year.</p> <p>For example, if a licensed person provides margin lending with a margin limit that may be drawn down by a client then the undrawn portion of the margin limit will be treated as a commitment with maturity of less than one year. Also refer to article 4-174 and 4-175 for treatment of margin lending.</p> <p>Another example would be if a licensed person executes a trade on behalf of the client and is held liable for the client’s trade then the licensed person will need to treat any exposure arising from expected settlement of the transaction as a binding off balance sheet commitment. Any cash margin held by the client with the licensed person for that specific trade will be treated as collateral against the commitment.</p>	20%
<p><b>Commitments</b> representing the undrawn portion of any binding arrangements with an original maturity of over one year.</p>	50%
<p><b>Other Commitments:</b> These include all other arrangements/commitments that are not specified anywhere.</p>	100%

**Article 4-93**

The add-on factors for foreign exchange, gold, precious metals (other than gold), other commodities and interest rate derivative contracts are outlined in Article 4-137 (Table 10).

**D.3 Credit Risk Mitigation**

**Article 4-94**

This section sets out the detailed requirements for the recognition and use of credit risk mitigation techniques (CRM). In particular, this section sets out the recognition requirements, the types of CRM techniques recognised by the Capital Markets Authority (eligible collateral, netting and guarantees), and the calculation of adjusted risk charge for exposures with recognised CRM techniques.

### D.3.A Recognition Requirements

#### Article 4-95

Licensed persons may use CRM techniques to reduce their risk charge of credit risk exposures if the following recognition requirements are satisfied:

- a. All documentation used for CRM purposes must be binding on all parties and legally enforceable in all relevant jurisdictions. Licensed persons must have conducted sufficient legal reviews to verify this and have a well-founded legal basis to reach this conclusion. Such reviews should be re-conducted whenever necessary to ensure continued enforceability of the documents.
- b. No supervisory recognition of credit risk mitigation (CRM) techniques will be taken into account if the credit enhancement is already reflected in the issue/exposure specific rating. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on exposures for which an issue-specific rating is used that already reflects that CRM.
- c. The legal mechanism by which collateral is pledged or transferred must ensure that licensed persons have the right to liquidate or to take legal possession of the collateral in a timely manner in the event of default, insolvency, bankruptcy (or other pre-defined credit events in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral).
- d. Licensed persons must take all necessary steps to fulfil the requirements under the law applicable to the licensed person's interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a register, or for exercising a right to net or set off in relation to title transfer of the collateral.
- e. Where the collateral is held by a custodian, licensed persons must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.
- f. The credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible for capital adequacy purposes.

**Article 4-96**

The following types of CRM techniques are recognised for the reduction of the risk charge of a credit exposure, provided that they fulfil the recognition conditions set out above:

- a. **Collateral:** A collateralised transaction is one in which licensed persons have a credit exposure or potential credit exposure which is hedged in whole or in part by collateral posted by a counterparty or by a third-party on behalf of the counterparty in accordance with sections (D.3.B/C)
- b. **On-balance sheet netting:** Where licensed persons have legally enforceable netting arrangements for assets and liabilities they may calculate capital requirements on the basis of net credit exposures subject to the conditions set out in section (D.3.D) below.
- c. **Bilateral netting:** Where licensed persons have legally enforceable master netting arrangements with their counterparties for derivative and repo transactions, they may calculate capital requirements on the basis of net credit exposures subject to the conditions set out in section (D.3.E) below.
- d. **Guarantees:** Where guarantees are direct, explicit, irrevocable and unconditional in accordance with section (D.3.F). Only guarantees issued by entities with a lower risk charge than the counterparty will lead to reduced capital charges. The uncovered portion, however, should retain the risk charge of the underlying counterparty.

### D.3.B Eligible Collateral

#### Article 4-97

The following types of financial collateral are eligible for recognition:

- a. Cash on deposit with a bank, including certificates of deposit or comparable instruments issued by a bank.
- b. Gold.
- c. Debt securities issued by.
  - i. The government of any GCC country.
  - ii. GCC PSEs in their domestic currencies.
  - iii. Other sovereigns or foreign PSEs that are treated as sovereigns in the relevant countries. The sovereigns or the sovereigns in which the PSE are incorporated must be rated by a recognised ECAI with their ratings equivalent to Credit Quality Grade (Sovereigns) of 4 or better. Debt securities issued by GCC PSEs in foreign currencies will be subject to this minimum rating condition.
  - iv. Foreign PSEs that are not treated as sovereigns in the relevant countries. The sovereigns in which the PSEs are incorporated must be rated by a recognised ECAs with their ratings equivalent to Credit Quality Grade (Sovereigns) of 3 or better.
- d. Short-term debt instruments issued by banks and with an investment grade short-term rating from a recognised ECAs.
- e. Debt securities not rated by recognised ECAs but meeting all of the following conditions:
  - i. Issued by a bank.
  - ii. Listed on a recognised exchange.
  - iii. Classified as senior debt.
  - iv. All rated issues of the same seniority by the issuing licensed person are rated equivalent to investment grade by a recognised ECAs.
  - v. The concerned licensed person holding the securities as collateral has no information to suggest that the issue justifies a rating below investment grade.
- f. Equities that are included in a main index or listed on a recognised exchange.
- g. Collective investment schemes (CIS) where:
  - i. A price for the units is publicly quoted daily.
  - ii. The CIS is limited to investing in instruments recognised as eligible collateral.

#### Article 4-98

Where a licensed person takes eligible collateral from a counterparty of a credit exposure or a third-party on behalf of the counterparty, it is allowed to take account of the risk mitigating effect of the collateral in calculating the capital requirement.



**D.3.C Collateral Measurement methodology**

**Article 4-99**

The approach for calculation of collateralised exposures allows for fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral.

**Article 4-100**

Through the formula given below, the capital requirement of a collateralised transaction based on the net credit exposure to a counterparty ( $E^*$ ) is calculated. In determining the net exposure, haircuts should be applied to the value of any collateral received in support of the counterparty ( $H_C$ ) to take account of future fluctuations in value. When the exposure and collateral are denominated in different currencies, an additional haircut ( $H_{FX}$ ) will be applied to the collateral to make some allowance for future fluctuations in foreign exchange rates.

$$E^* = \max [0, \{E - C \times (1 - H_C - H_{FX})\}]$$

Where:

$E^*$  = Net credit exposure (i.e. exposure value after CRM).

$E$  = Outstanding Exposure, which is net of specific provisions, if any. For off-balance sheet exposures, it is the credit equivalent amount.

$C$  = Value of the collateral before CRM.

$H_C$  = Haircut appropriate to the collateral.

$H_{FX}$  = Haircut appropriate for currency mismatch between the exposure and the collateral fixed at 8%.

**Article 4-101**

Where the collateral is a basket of assets, the haircuts on the basket ( $H_A$ ) will be calculated as:

$$H_A = \sum a_i \times H_i$$

Where:

$a_i$  = Weight of the asset in the basket.

$H_i$  = Haircut applicable to that asset.

This haircut  $H_A$  will replace the  $H_C$  in the formula shown in Article 4-100 above.

**Article 4-102**

To obtain the risk charge of a collateralised transaction, licensed persons should multiply the value of the net credit exposure ( $E^*$ ) by the risk charge of the counterparty, not that of the collateral instruments.

Article 4-103

**D.3.C.i Standard Supervisory haircuts**

Licensed persons are required to use the standard haircuts for the calculation of collateralised exposures. The assumptions under the standard haircuts are daily mark-to-market, daily re-margining, and a 10-business-day holding period. The haircuts as given below in percentages, apply to both the collateral value (HC). Exposure amount may vary where, for example, securities are being lent or where the licensed person is exposed to securities supported by collaterals:

Table 8: Standard supervisory haircuts

Credit Quality Grades	Residual maturity	Sovereigns	Other Issuers
Grade 1	<=1 year	0.5%	1%
	>1 year <=5 years	2%	4%
	> 5 years	4%	8%
Grade 2 & 3 Includes unrated securities issued by banks satisfying the criteria for eligible collateral	<=1 year	1%	2%
	>1 year <=5 years	3%	6%
	> 5 years	6%	12%
Grade 4	All	15%	Not Eligible
Main index equities (including convertible bonds) and Gold		15%	
Other equities (including convertible bonds)		25%	
UCITS/mutual funds		Highest haircut applicable to any security in fund	
Cash in the same currency		0%	

**D.3.C.ii Adjustment for different holding periods and non-daily revaluation and re-margining**

**Article 4-104**

The framework for collateral haircuts distinguishes between repo-style transactions, other capital market driven transactions (i.e. OTC derivatives and margin lending) and secured lending. The appropriate haircut to be used for each of these types of transactions depends on the frequency of the re-margining and revaluation and the assumed minimum holding period for the type of transaction. Provided the transactions are subject to daily revaluation or re-margining, their minimum holding periods are as follows:

Table 9: Revaluation or re-margining conditions for holding periods

Transaction Type	Minimum Holding Period	Condition
Repo-style transactions	5 business days	Daily re-margining
Other capital market transactions	10 business days	Daily re-margining
Secured lending	20 business days	Daily revaluation

**Article 4-105**

For a repo-style or secured lending or any other transactions which has a holding period different from 10 business days or is not re-margined or revalued daily as assumed in the standard supervisory haircuts, licensed persons are required to scale up or down the standard haircuts ( $H_C$  and  $H_{FX}$ ) depending on the type of transaction and the frequency of re-margining or revaluation. The calculation can be expressed as follows:

$$H = H_{10} * \sqrt{(N_R + (T_M - 1)) / 10}$$

Where:

**H** = Haircut after adjustment for differences in holding period and revaluation frequency.

**H<sub>10</sub>** = Standard supervisory haircuts based on a minimum holding period of 10 business days.

**T<sub>M</sub>** = Minimum holding period for the type of transaction (i.e. 5 business days for repo-style transactions or 20 business days for secured lending).

**N<sub>R</sub>** = Actual number of business days between re-margining for capital market transactions or revaluation for secured transactions.

**Article 4-106**

As the determination of appropriate haircuts is based on the type of transaction, as well as on certain assumptions about the revaluation frequency and holding period of the collateral, licensed persons are required to have robust internal policies, systems and procedures for collateral management, covering the revaluation of collateral, and the assumptions on the holding periods of collateral.

**Article 4-107** For repo-style transactions that are treated as collateralised loans (i.e. reverse repo transactions or securities borrowing against cash collateral), all assets received by the licensed person may be recognised for CRM purposes. Assets falling outside the definition of eligible collateral (as set out in the table above) should be subject to a 25% haircut.

**D.3.C.iii Conditions for zero haircuts**

**Article 4-108** For certain type of repo-style transactions that satisfy all of the following conditions, the supervisory haircut will be zero:

- a. The counterparty is one of the following core market participants:
  - i. Sovereigns, central banks and PSEs.
  - ii. Banks.
  - iii. Other financial entities with CQG of 1.
  - iv. Regulated CIS that are subject to capital or leverage requirements.
  - v. Regulated pension funds.
  - vi. Recognised clearing organisations or other Financial Market Infrastructures.
- b. Both the exposure and the collateral are denominated in the same currency.
- c. Either the transaction is overnight or both the exposure and the collateral are marked-to-market daily and are subject to daily re-margining.
- d. Following the counterparty's failure to re-margin, the time that is required between the last mark-to-market before the failure to re-margin and the liquidation of the collateral is considered to be no more than four business days.
- e. The transaction is settled across a settlement system proven for that type of transaction.
- f. Standard market documentation in the securities concerned is used for the agreement covering the repo-style transactions.
- g. The documentation of the transaction should specify that the transaction is immediately terminable if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults.
- h. Upon any event of default, regardless of whether the counterparty is insolvent or bankrupt, the licensed person should have an unfettered and legally enforceable right to immediately seize and liquidate the collateral for its benefit.

### D.3.D Capital treatment of on-balance sheet netting

#### Article 4-109

Where a licensed person:

- a. has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt.
- b. is able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement.
- c. monitors and controls its roll-off risks.
- d. monitors and controls the relevant exposures on a net basis.

The licensed person may use the net exposure of assets and liabilities as the basis for its calculation of the risk charges in accordance with the formula in article 4-100. Assets are treated as exposure and liabilities as collateral. The haircuts will be zero except when a currency mismatch exists. A 10-business day holding period will apply when daily mark-to-market is conducted and all the requirements contained in articles 4-103, 4-105 and 4-123 to 4-127 will apply.

#### Article 4-110

The net credit exposure with a counterparty, adjusted for the CRM effect of a valid on-balance sheet netting agreement, is calculated using the following formula:

$$\text{Net credit exposure} = \max [0, (\text{Assets} - \text{Liabilities}) \times (1 - H_{FX})]$$

where:

$H_{FX}$  is the haircut, which is 8%, to be applied in the case of a currency mismatch between assets and liabilities. The haircut assumes a minimum holding period of 10-business days and a daily mark-to-market. It should be adjusted according to the formula set out in article 4-103 for a different minimum holding period and/or frequency of revaluation.

#### Article 4-111

The risk charge for transactions with on-balance sheet netting agreements is calculated by multiplying the net credit exposure by the risk charge of the counterparty.

#### Article 4-112

For off-balance sheet items, licensed persons are required to calculate the credit equivalent amount after taking into effect the netting arrangements, and multiply the credit equivalent amount by the risk charge of the counterparty to derive the risk charge.

### D.3.E Bilateral netting

#### Article 4-113

Licensed persons are allowed to net exposures arising from exchange rate, gold and interest rate contracts with the same counterparty provided that they are subject to a valid bilateral netting agreement. The bilateral netting agreement for derivative contracts may cover only a single type or more than one type of contracts.

#### Article 4-114

Further guidelines on bilateral netting in the context of repo-style and derivative transactions are provided under article 4-171 and articles 4-140 to 4-145 of these guidelines respectively.

### D.3.F Capital treatment of guarantees and related conditions

#### Article 4-115

In order for a guarantee or a counter-guarantee to be recognised, the following conditions must be satisfied:

- a. It must represent a direct claim on the guarantor.
- b. The guarantee should be explicitly referenced to specific exposures or a pool of exposures, so that the extent of cover is clearly defined and incontrovertible.
- c. Other than a non-payment by a protection purchaser of money due in respect of the guarantee contract, there should be no clause in the guarantee contract that would allow the guarantor to cancel the credit cover unilaterally or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure.
- d. It must also be unconditional, i.e. there should be no clause in the guarantee contract that could prevent the guarantor from being obliged to pay out promptly in the event that the underlying borrower fails to make the payment(s) due.
- e. The country where the guarantor is located or incorporated should either have no exchange controls or, where there are exchange controls, approval should have been obtained for the funds to be remitted freely in the event of a call on the obligation.
- f. On the qualifying default/non-payment of the counterparty, the licensed person may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the licensed person, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The licensed person must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment.
- g. The guarantee is an explicitly documented obligation assumed by the guarantor.
- h. The guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments etc. Where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount.

**Article 4-116** When calculating the risk charge for exposures fully secured by guarantees, the risk charge of the underlying obligor must be replaced with the risk charge of the guarantor.

**Article 4-117** Where the amount guaranteed is less than the whole amount of the underlying exposure, and the licensed person and the guarantor share losses on a pro-rata basis, the protected portion is assigned the risk charge of the guarantor while the uncovered portion is assigned the risk charge of the underlying obligor.

**Article 4-118** Where a foreign currency mismatch occurs i.e. when the credit protection is denominated in a currency different from that of the underlying obligation, the portion covered by the credit protection should be reduced by a standard haircut of 8%.

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

Where:

**G<sub>A</sub>** = the amount of the exposure covered by credit protection and adjusted for currency mismatch.

**G** = Nominal amount of the credit protection.

**H<sub>FX</sub>** = Haircut appropriate for currency mismatch between the credit protection and underlying obligation (8%).

**Article 4-119** The 8% haircut is based on a 10-business day holding period and daily mark-to-market. This haircut has to be adjusted by using the formula set out in article 4-105 when the minimum holding period or the mark-to-market frequency of the transactions is different from that of the standard supervisory haircut.

**Article 4-120** Where an exposure is guaranteed by a sovereign, such an exposure may be treated as a claim on a sovereign and assigned a risk charge in accordance with the treatment applicable to an on-balance sheet claim on a sovereign.

**Article 4-121** Where an exposure is counter-guaranteed by a sovereign, such an exposure may be treated as a claim on a sovereign and assigned a risk- charge in accordance with the treatment applicable to an on-balance sheet claim on a sovereign provided that:

- a. The sovereign counter-guarantee covers all credit risk elements of the underlying exposure.
- b. Both the original guarantee and the counter-guarantee meet all requirements for guarantees mentioned in article (4-115) above, except that the counter-guarantee need not be direct and explicit to the original claim.
- c. The cover is robust and there is no evidence to suggest that the coverage of the counter-guarantee is less effective than that of a direct sovereign guarantee.

**D.3.F.i Eligible guarantors (counter-guarantors)**

**Article 4-122**

Credit protection given by the following entities will be recognised:

- a. Sovereign entities, PSEs, banks, and securities firms with a lower risk charge than the counterparty.
- b. Other entities that are externally rated except when credit protection is provided to a securitisation exposure. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk charge than the obligor.
- c. When credit protection is provided to a securitisation exposure, other entities that are currently externally rated BBB- or better and that were externally rated A- or better at the time the credit protection was provided. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk charge than the obligor.

**D.3.F.ii Maturity mismatches**

**Article 4-123**

A maturity mismatch occurs when the residual maturity of a hedge is less than that of the underlying exposure.

**Article 4-124**

The maturity of the underlying exposure and the maturity of the hedge should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the obligor is scheduled to fulfil its obligation, taking into account any applicable grace period. For the hedge, embedded options which may reduce the term of the hedge should be taken into account such that the shortest possible effective maturity should be used. Where a call is at the discretion of the protection provider, the maturity will always be the first call date. If the call is at the discretion of the licensed person as the protection buyer but the terms of the arrangement of obligation of the hedge contain a positive incentive for the licensed person to call the transaction before contractual maturity, the remaining time to the first call date will be deemed to be the effective maturity.

**Article 4-125**

All CRM techniques (i.e. Collateral, On-Balance Sheet Netting, Bilateral Netting Agreements, and Guarantees) will be recognised for capital purposes when the hedge has an original maturity of longer than or equal to one year. As a result, the maturity of hedges for exposures with original maturities of less than one year must be matched to be recognised. In all cases, hedges with maturity mismatches will no longer be recognised when the hedges have a residual maturity of three months or less.



**Article 4-126**

Where a recognised maturity mismatch exists, the value of the CRM protection should additionally be adjusted based on the following formula:

$$P_a = P \times (t - 0.25) / (T - 0.25)$$

Where:

$P_a$  = Value of credit protection adjusted for maturity mismatch.

$P$  = Value of credit protection adjusted for any haircuts.

$t$  = min (T, residual maturity of the credit protection arrangement) expressed in years.

$T$  = min (5, residual maturity of the underlying exposure) expressed in years.

**Article 4-127**

Licensed persons must ensure that sufficient resources are devoted to the orderly operation of margin agreements with OTC derivative and securities-financing counterparties, as measured by the timeliness and accuracy of its outgoing calls and response time to incoming calls. Licensed persons must have collateral management policies in place to control, monitor and report:

- a. The risk to which margin agreements exposes them (such as the volatility and liquidity of the securities exchanged as collateral).
- b. The concentration risk to particular types of collateral.
- c. The reuse of collateral (both cash and non-cash), including the potential liquidity shortfalls resulting from the reuse of collateral received from counterparties;
- d. the surrender of rights on collateral posted to counterparties.

## E. Counterparty Credit Risk

### E.1 Scope of Application

- Article 4-128** The CCR Methodology for counterparty credit risk described in this section is applicable to OTC derivatives and long settlement transactions. Repo transactions and Securities Financing Transactions (SFTs) are subject to treatment under articles 4-168 to 4-179 of these Guidelines for the purpose of computation of counterparty credit risk capital requirements.
- Article 4-129** Exposures to central counterparties arising from OTC derivatives, exchange traded derivatives transactions and long settlement transactions will be subject to the counterparty credit risk treatment laid out in the articles 4-151 to 4-167 below. Exposures arising from the settlement of cash transactions (equities, fixed income, spot FX and spot commodities) are not subject to this treatment.
- Article 4-130** Instruments listed in article (4-129) above generally exhibit the following characteristics:
- The transactions generate a current exposure or market value.
  - The transactions have an associated random future market value based on market variables.
  - The transactions generate an exchange of payments or an exchange of a financial instrument (including commodities) against payment.
- Article 4-131** Other common characteristics of the transactions (refer to article 4-129) may include the following:
- Collateral may be used to mitigate risk exposure and is inherent in the nature of some transactions.
  - Netting may be used to mitigate the risk.
  - Positions are frequently valued (most commonly on a daily basis), according to market variables.
  - Re-margining may be employed.
- Article 4-132** When the clearing member-to-client leg of an exchange traded derivatives transaction is conducted under a bilateral agreement, both the licensed person and the clearing member are to capitalise that transaction as an OTC derivative.
- Article 4-133** Since credit derivatives are not recognised as an eligible form of CRM, when a licensed person purchases credit derivative protection against an exposure, or against a counterparty credit risk exposure, it will determine its capital requirement for the hedged exposure by not taking any recognition of credit derivatives. In addition, a separate counterparty credit risk charge should be applied on the credit derivative contract, as applicable.
- Article 4-134** The exposure amount for a given counterparty is equal to the sum of the exposure amounts calculated for each netting set with that counterparty.

## E.2 CCR Exposure Methodology

### Article 4-135

This section sets the rules for estimating the exposure amount for positions in instruments subject to counterparty credit risk (CCR) exposure.

### Article 4-136

Licensed persons must calculate the current replacement cost by marking contracts to market, thus capturing the current exposure without any need for estimation, and then adding a factor (the “add-on”) to reflect the potential future exposure over the remaining life of the contract. In order to calculate the credit equivalent amount of these instruments a licensed person would sum:

- a. The total replacement cost (obtained by “marking to market”) of all its contracts with positive value. For long settlement transactions, replacement cost is the settlement amount.
- b. An amount for potential future credit exposure calculated on the basis of the total notional principal amount of its book, split by residual maturity and type of the contract as follows:

$$\text{PFE} = \text{Notional amount} * \text{add-on factor}$$

Where:

PFE: Potential Future Exposure

Add-on factors as outlined in next Article 4-137.

**Article 4-137**

Add-on factors are a function of the residual maturity of the contract and the underlying and are calculated as below:

Table 10: Add-on factors for derivative contracts

Residual Maturity	Add-on factor
Foreign exchange contracts: These include cross-currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased, gold contracts and similar instruments bearing credit risk. The add-on factor for such contracts shall be determined based on residual maturity as follows:	
1 year or less	1.0%
Over 1 year to 5 years	5.0%
Over 5 years	7.5%
Interest rate contracts: They include Single Currency Interest Rate Swaps; Forward Interest Rate Agreements; all types of interest rate options purchased, and similar instruments involving credit risk. The add-on factors for such contracts shall be determined based on residual maturity as follows:	
1 year or less	Nil
Over 1 year to 5 years	0.5%
Over 5 years	1.5%
Equity contracts: These include equity swaps, forward equity contracts, currency futures, equity options purchased and similar instruments bearing credit risk. The add-on factor for such contracts shall be determined based on residual maturity as follows:	
1 year or less	6.0%
Over 1 year to 5 years	8.0%
Over 5 years	10.0%
Contracts in precious metals (other than gold): These include all contracts in precious metals (other than gold) bearing credit risk. The add-on factor for such contracts shall be determined based on residual maturity as follows:	
1 year or less	7.0%
Over 1 year to 5 years	7.0%
Over 5 years	8.0%
Other commodities: These include all contracts bearing credit risk. The add-on factor for such contracts shall be determined as follows:	
1 year or less	10.0%
Over 1 year to 5 years	12.0%
Over 5 years	15.0%

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**Notes:**

- a. For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- b. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria (i.e. Section E.1), the add-on factor is subject to a floor of 0.5%.
- c. Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of this matrix are to be treated as “other commodities”.
- d. No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

**Article 4-138** When calculating the effective future amount, the effective rather than apparent notional amounts should be used by the licensed person in the event that these contracts contain leveraged structure to enhance the notional amount.

**Article 4-139** Licensed persons can obtain capital relief for collateral as defined in articles 4-94 to 4-127 of these Guidelines. The methodology for the recognition of eligible collateral follows that of the applicable approach for credit risk.

**E.2.A Bilateral Netting Agreement**

**Article 4-140** Exposures to the same counterparties arising out of a range of forwards, swaps, options and similar derivative contracts, could be subject to a netting treatment according to the following requirements (i.e. article 4-141).

**Article 4-141**

Accordingly, for capital requirement calculation purposes:

- a. Licensed persons may net transactions subject to novation under which any obligation between a licensed person and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.
- b. Licensed persons may also net transactions subject to any legally valid form of bilateral netting not covered in (a), including other forms of novation.
- c. In both cases (a) and (b), a licensed person will need have:
  - i. A netting contract or agreement with the counterparty which creates a single legal obligation, covering all included transactions, such that the licensed person would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances.
  - ii. Written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the licensed person's exposure to be such a net amount under:
    - The law of the jurisdiction in which the counterparty is chartered and the branch that conducted the netting.
    - The law that governs the individual transactions.
    - The law that governs any contract or agreement necessary to effect the netting.
  - iii. In this context, licensed persons will use the following applicable market accepted standard agreements:
    - International Swaps and Derivatives Association (ISDA) Master Agreement (English Law or New York Law, as applicable).
    - International Foreign Exchange Master Agreement (IFEMA) for FX transactions.
    - FX Net Agreements for FX transactions.
    - Worldwide Foreign Exchange Netting and Close-Out Agreement for FX transactions.
    - Global Foreign Exchange Netting and Close-Out Agreement (FXNET “Non-User” Agreement) for FX transactions.
    - International Currency Option Master Agreement (ICOM).
  - iv. Licensed persons are only permitted to avail the benefit of Master Netting Agreements in jurisdictions where such agreements are legally enforceable (i.e. where legal precedence exists). The use of such netting should also be supported by the positive opinion of the licensed person's Legal Department.
  - v. Licensed persons intending to use any Master Netting Agreements other than those listed in previous article should seek the explicit approval of the CMA to do so.

**Article 4-142**

In certain arrangements (such as contracts including ‘walk away clauses’) where the counterparty terminates the contract, this event is not taken into consideration for the purposes of calculating the capital adequacy. Thus, the exposure is calculated without taking into account the Netting Agreement.

**Article 4-143** Credit exposure on bilaterally netted derivative transactions will be calculated as the sum of the net mark-to-market replacement cost, if positive, plus an add-on based on the notional underlying principal. The add-on for netted transactions (ANet) will equal the weighted average of the gross add-on (AGross) and the gross add-on adjusted by the ratio of net current replacement cost to gross current replacement cost (NGR). This is expressed through the following formula:

$$A_{Net} = 0.4 * A_{Gross} + 0.6 * NGR * A_{Gross}$$

Where:

**NGR**= level of net replacement cost/level of gross replacement cost for transactions subject to legally enforceable netting agreements.

**Article 4-144** The scale of the gross add-ons to apply in this formula (Mentioned in article 4-143) will be the same as those for non-netted transactions as set out in articles 4-136 to 4-143 of these Guidelines.

**Article 4-145** For purposes of calculating potential future credit exposure to a netting counterparty for forward foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, notional principal is defined as the net receipts falling due on each value date in each currency.

#### E.2.B Calculation of the CCR risk capital charge

**Article 4-146** The total CCR capital charge, for licensed persons for counterparty credit risk exposure, is determined as:

$$CCR \text{ charge} = [(RC + A_{Net}) - CA] \times rw \text{ charge } \%$$

Where:

**RC** = the replacement cost (i.e. the current positive market value of the netting set).

**ANet** = the add-on amount for potential future exposure calculated according to article 4-143.

**CA** = collateral amount or zero if no eligible collateral is applied to the transaction.

**rw charge %** = the credit risk charge of the counterparty.

An illustration of the CCR calculation, is provided in Appendix 4 (Example 7).

### E.3 Credit Value Adjustment (CVA)

- Article 4-147** Licensed persons are required to add a capital charge to cover the risk of mark-to-market losses of OTC derivatives.
- Article 4-148** These mark-to-market losses are known as the credit value adjustments (CVA).
- Article 4-149** Licensed persons are required to calculate a CVA charge as 20% of CCR charge.
- Article 4-150** An illustration of the CVA calculation is provided in Appendix 4 (Example 7).

### E.4 Exposures to Central Counterparties

- Article 4-151** Licensed persons retain the responsibility to ensure that they maintain adequate capital for exposures to CCPs.
- Article 4-152** Where the licensed person is acting as a clearing member, the licensed person should assess whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of those transactions. This assessment will include potential future or contingent exposures resulting from future drawings on default fund commitments, and/or from secondary commitments to replace offsetting transactions from clients of another clearing member in case of this clearing member defaulting or becoming insolvent.
- Article 4-153** Where a licensed person is trading with a QCCP as defined in “Definitions” above, then articles 4-154 to 4-166 of these Guidelines will apply. In the case of non-qualifying CCPs, article 4-167 of these Guidelines will apply. When a central counterparty ceases to qualify as a QCCP, the Capital Markets Authority requires licensed persons to apply the risk charge applicable to non-qualifying CCPs with immediate effect, according to Article 4-167 of these Guidelines.



## E.4.A Exposures to Qualifying CCPs

### E.4.A.i Clearing and settlement exposures

#### a. Clearing member exposures

#### Article 4-154

Where a licensed person acts as a clearing member of a CCP for its own purposes, a risk charge of 0.3% must be applied to the licensed person's trade exposure to the CCP in respect of OTC derivatives, exchange traded derivative transactions and SFTs. Where the clearing member offers clearing services to clients, the 0.3% risk charge also applies to the clearing member's trade exposure to the CCP that arises when the clearing member is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults.

#### Article 4-155

The exposure amount for such trade exposure is to be calculated in accordance with article 4-128 using the CCR Methodology, as consistently applied by such licensed person to such an exposure in the ordinary course of its business, or articles 4-97 and 4-99 together with credit risk mitigation techniques set forth in this regulation for collateralised transactions.

#### Article 4-156

Where settlement is legally enforceable on a net basis in an event of default and regardless of whether the counterparty is insolvent or bankrupt, the total replacement cost of all contracts relevant to the trade exposure determination can be calculated as a net replacement cost if the applicable netting agreements meet the requirements set out in:

- a. Article 4-176 and where applicable, also Article 4-177 of the Guidelines in the case of repo-style transactions.
- b. Articles 4-140 to 4-142 of these Guidelines in the case of derivative transactions. To the extent that the rules referenced above (a,b) include the term "master netting agreement", this term should be read as including any "netting agreement" that provides legally enforceable rights of set-off. If the licensed person cannot demonstrate that netting agreements meet these rules (a, b), each single transaction will be regarded as a netting set of its own for the calculation of trade exposure.

#### Article 4-157

The clearing member will always capitalise its exposure (including potential CVA risk exposure) to clients as bilateral trades, irrespective of whether the clearing member guarantees the trade or acts as an intermediary between the client and the CCP. However, to recognise the shorter close-out period for cleared transactions, clearing members can capitalise the exposure to their clients by multiplying the exposure amount by a scalar of no less than 0.71.

**b. Client exposures**

**Article 4-158**

Where a licensed person is a client of a clearing member, and enters into a transaction with the clearing member acting as a financial intermediary (i.e. the clearing member completes an offsetting transaction with a CCP), the client's exposures to the clearing member may receive the treatment in articles 4-154 to 4-156 of this section if the two conditions (a, b) below are met. Likewise, where a client enters into a transaction with the CCP, with a clearing member guaranteeing its performance, the client's exposures to the CCP may receive the treatment in articles 4-154 to 4-156 if the following two conditions are met:

- a. The offsetting transactions are identified by the CCP as client transactions and collateral to support them is held by the CCP and/or the clearing member, as applicable, under arrangements that prevent any losses to the client due to: (i) the default or insolvency of the clearing member, (ii) the default or insolvency of the clearing member's other clients, and (iii) the joint default or insolvency of the clearing member and any of its other clients.  
The client must be in a position to provide to the Capital Markets Authority, if requested, an independent, written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and administrative authorities would find that the client would bear no losses on account of the insolvency of an intermediary clearing member or of any other clients of such intermediary under relevant law:
  - i. The law of the jurisdiction(s) of the client, clearing member and CCP.
  - ii. If the foreign branch of the client, clearing member or CCP are involved, then also under the law of the jurisdiction(s) in which the branch are located.
  - iii. The law that governs the individual transactions and collateral.
  - iv. The law that governs any contract or agreement necessary to meet this condition (a).
- b. Relevant laws regulation rules contractual or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, should the clearing member default or become insolvent. In such circumstances, the client positions and collateral with the CCP will be transferred at market value unless the client requests to close out the position at market value.

**Article 4-159**

Where a licensed person is not protected from losses in the case that the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions in the preceding article (i.e. 4-158) are met, a risk charge of 0.6% will apply to the licensed person's exposure to the clearing member.

**Article 4-160**

Where the licensed person is a client of the clearing member and the requirements in articles 4-158 to 4-159 are not met, the licensed person will capitalise its exposure (including potential CVA risk exposure) to the clearing member as a bilateral trade.

**c. Treatment of posted collateral**

**Article 4-161**

In all cases, any assets or collateral posted must, from the perspective of the licensed person posting such collateral, receive the risk charge that otherwise applies to such assets or collateral under the capital adequacy Guidelines, regardless of the fact that such assets have been posted as collateral. Where assets or collateral of a clearing member or client are posted with a CCP or a clearing member and are not held in a bankruptcy remote manner, the licensed person posting such assets or collateral must also recognise credit risk based upon the assets or collateral being exposed to risk of loss based on the creditworthiness of the entity holding such assets or collateral.

**Article 4-162**

Collateral posted by the clearing member (including cash, securities, other pledged assets and excess initial or variation margin also called over-collateralisation), that is held by a custodian, and is bankruptcy remote from the CCP, is not subject to a capital requirement for counterparty credit risk exposure to such bankruptcy remote custodian.

**Article 4-163**

Collateral posted by a licensed person, that is held by a custodian, and is bankruptcy remote from the CCP, the clearing member and other clients, is not subject to a capital requirement for counterparty credit risk. If the collateral is held at the CCP on a licensed person's behalf and is not held on a bankruptcy remote basis, a 0.3% risk charge must be applied to the collateral if the conditions established in article 4-158 of this guideline are met; or 0.6% if the conditions in article 4-159 of this guideline are met.

**E.4.A.ii Default fund exposures**

**Article 4-164**

Where a default fund covers transactions with settlement risk only (e.g. equities and bonds) or counterparty credit risk i.e. OTC derivatives, exchange traded derivatives or SFTs, all of the default fund contributions will receive the risk charge determined according to the formulae and methodology set forth below (article 4-166), without apportioning to different classes or types of business or products. However, where the default fund contributions from clearing members are segregated by product types and only accessible for specific product types, the capital requirements for those default fund exposures determined according to the formulae and methodology set forth below (article 4-166) must be calculated for each specific product giving rise to counterparty credit risk. In case the CCP's prefunded own resources are shared among product types, the CCP will have to allocate those funds to each of the calculations, in proportion to the respective product specific credit exposure amount.

**Article 4-165**

Whenever a licensed person is required to capitalise for exposures arising from default fund contributions to a qualifying CCP, clearing member entities will need to apply the following Method (article 4-166).

**Article 4-166** Clearing member entities may apply a risk charge of 187.5% to its default fund exposures to the CCP, subject to an overall cap on the risk charge from all its exposures to the CCP (i.e. including trade exposures) equal to 3% of the trade exposures to the CCP. More specifically, under this approach, the risk charge for both licensed person i's trade and default fund exposures to each CCP are equal to:

$$\text{Min} \{(0.3\% * TE_i + 187.5\% * DF_i); (3\% * TE_i)\}$$

Where

**TE<sub>i</sub>** = licensed person i's trade exposure to the CCP, as measured by the licensed person according to articles 4-154 to 4-156 of this section.

**DF<sub>i</sub>** = licensed person i's pre-funded contribution to the CCP's default fund.

#### E.4.A.iii Exposures to Non- Qualifying CCPs

**Article 4-167** Licensed persons must apply the rules for credit risk in these Guidelines, according to the category of the counterparty, to their trade exposure to a non-qualifying CCP. Licensed persons must apply a risk charge of 187.5% to their default fund contributions to a non-qualifying CCP. For the purposes of this article, the default fund contributions of such licensed persons will include both the funded and the unfunded contributions which are liable to be paid should the CCP so require.

### F. Securities Financing Transactions

#### F.1 Repurchase Agreement

**Article 4-168** The capital treatment of repo-style transactions (repos and reverse repos of securities) depends mainly on whether there is any substantial transfer of risk and rewards of ownership to the counterparty.

**Article 4-169** Where all risks and rewards of ownership are substantially transferred to the counterparty, the following capital treatment shall apply:

- a. The securities sold under the repo agreement should be treated as an off-balance sheet commitment to repurchase with a capital requirement provided for the credit risk to the issuer of the securities.
- b. Securities purchased (reverse repo transaction) should be treated as an asset with a capital requirement provided for the credit risk to the issuer of the securities.

**Article 4-170** | Where there is no substantial transfer of all risks and rewards of ownership to the counterparty, the following capital treatment shall apply:

- a. The securities sold under the repo agreement should be treated as an asset with a capital requirement provided for the credit risk to the issuer of the securities.
- b. A reverse repo transaction should be treated as collateralised lending with a capital requirement provided for the credit risk to the counterparty, but shall be mitigated through applying the general capital rules for CRM treatment of collateralised transactions (see articles 4-94 to 4-127).

**Article 4-171** | In calculating credit risk capital requirements for repo transactions, licensed persons may recognise any standard bilateral netting agreements such as the Global Master Repurchase Agreement (GMRA) or the Tri-partite Repo Service Agreement (TRSA).

### F.2 Securities Borrowing and Lending

**Article 4-172** | For securities borrowing, the capital treatment depends on whether the collateral is cash or other securities.

- a. If the collateral is cash, the exposure should be treated as a collateralised loan to the counterparty. If the securities borrowed qualify as eligible collateral, the rules for CRM treatment of collateralised transactions shall apply.
- b. If the collateral is securities, it should be treated as an asset with a capital requirement provided for the credit risk to the issuer of the securities.

**Article 4-173** | Securities lent should continue to be treated as an asset with a capital requirement provided for the credit risk to the issuer of the securities.

### F.3 Margin Lending

**Article 4-174** | Any margin limit that may be drawn down by a client is treated as an off-balance sheet commitment (Refer to article 4-92). Drawn portion of the margin limit will be considered as an on-balance sheet exposure subject to capital charges for credit risk as applicable to the counterparty (Refer to articles 4-63 to 4-87).

**Article 4-175** | The entire value of the securities bought on margin will be considered as collateral subject to legal contractual agreement with the client to enable use of this collateral against the licensed person's exposure.

The transaction should be treated as collateralised lending and shall be mitigated through applying the general capital rules for CRM treatment of collateralised transactions (see articles 4-94 to 4-127).

#### F.4 Treatment of Netting Agreements

##### Article 4-176

The effects of bilateral netting agreements covering repo-style transactions will be recognised on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must:

- a. Provide the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty.
- b. Provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other.
- c. Allow for the prompt liquidation or setoff of collateral upon the event of default.
- d. Together with the rights arising from the provisions required in a. to c. above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy.

##### Article 4-177

Netting across positions will only be recognised when the netted transactions fulfil the following conditions:

- a. All transactions are marked to market daily.
- b. The collateral instruments used in the transactions are recognised as eligible financial collateral.

##### Article 4-178

The formula below will apply to take into account the impact of master netting agreements in the context of repo transactions

$$E^* = \max \{0, [(E) - (C)] + \sum (E_s \times H_s) + \sum (E_{FX} \times H_{FX})\}$$

Where:

**E\*** = the exposure value after risk mitigation.

**E** = current value of the exposure.

**C** = the value of the collateral received.

**E<sub>s</sub>** = absolute value of the net position in a given security.

**H<sub>s</sub>** = haircut appropriate to E<sub>s</sub>.

**E<sub>FX</sub>** = absolute value of the net position in a currency different from the settlement currency.

**H<sub>FX</sub>** = haircut appropriate for currency mismatch (8%).

Refer to Appendix 4 (Example 8).

##### Article 4-179

All other rules for haircuts specified under article 4-103 to 4-108 above are also applicable in the context of repo transactions.

## G. Securities Underwriting Risks

### G.1 Introduction

#### Article 4-180

The activity of helping enterprises or governments raise investment capital by making a market for their securities is termed underwriting. Investment firms that agree to underwrite on a firm commitment basis help guarantee the sale of a new issue of securities in the primary market by promising to buy the portion of the issue that they are unable to sell in the market at the offer price.

### G.2 Treatment of Underwriting Risk

#### Article 4-181

Market conditions can deteriorate in the time between when the offer pricing is confirmed and the actual offer date. There exists the danger of overpricing in that the actual demand from investors is lower than expected.

### G.2.A Capital Charge for Underwriting Risk

#### G.2.A.i Risk Capital Charge for Equity/Debt Underwriting

#### Article 4-182

The underlying exposure in Equity or Debt (i.e. exposure on licensed person books after subscription) will need to be treated as a position in the licensed persons' balance sheet and will be subject to capital charge depending on type (Equity/Debt) and classification (FVTPL as per IFRS 9 or not).

#### G.2.A.ii Credit Risk Capital Charge for Equity/Debt Underwriting where underwriting agreement is voided with exposure to Issuer

#### Article 4-183

If the underwriting agreement between the issuer and the equity underwriter is voided before the offer date due to force majeure clauses and the underwriter has already paid for the issue, the underwriter is exposed to credit risk. This risk is often minimized by signing the agreement as close to the offer date as possible. Such exposure should be treated as an unsecured loan and credit risk capital charge should be calculated as per articles 4-63 to 4-127.

## H. Risk charge for Assets Under Management

#### Article 4-184

In cases where licensed persons hold, manage or administer client assets, a capital charge based on the Assets Under Management (AUM) is applicable as provided in this section.

- Article 4-185** Assets Under Management (AUM) are defined as the following:
- a. The amount of assets the licensed person manages for its clients under both discretionary portfolio management and non-discretionary arrangements constituting investment advice, including assets delegated to another undertaking and excluding assets that another undertaking has delegated to the licensed person.
  - b. The value of assets that a licensed person safeguards and administers for clients, including assets delegated to another undertaking and assets that another undertaking has delegated to the licensed person, irrespective of whether assets appear on the licensed person's own balance sheet or are segregated in other accounts.
- Article 4-186** AUM shall be calculated as the rolling average of the value of the total monthly assets under management, measured on the last business day of each of the previous 12 calendar months. AUM shall be the average or simple arithmetic mean of the 12 monthly measurements.
- Article 4-187** Where the licensed person has formally delegated the assets under management to another financial entity, those delegated assets shall be included in the total amount of AUM measured in accordance with article 4-186. Where another financial entity has formally delegated the assets under management to the licensed person, those delegated assets shall not be included in the total amount of assets under management measured in accordance with article 4-186.
- Article 4-188** Where a licensed person has been managing, safeguarding or administering assets for less than 12 months, it may use business projections of AUM, subject to the condition that historical data is used as soon as it becomes available.
- Article 4-189** The capital charge for Assets Under Management is calculated as 0.10% times rolling average AUM as calculated above.



**I. Other exposures**

**Article 4-190**

These include all exposures not specified elsewhere (excludes equity exposures that have been deducted from capital or subject to capital charge as per article 3-29).

**Article 4-191**

These exposures include:

- a. Exposures to, for instance, fixed assets, plant, equipment and machinery of the licensed person. Such exposures are subject to a 15% risk charge, or a higher risk charge as may be specified by the Capital Markets Authority, if the asset concerned, is considered to be of higher risk.
- b. Exposures resulting from Istisnã contracts, In case a parallel Istisnã contract is not executed which are subject to a risk-charge of 18% (article 6-27)
- c. Exposures to WIP inventory which are subject to a risk-charge of 30% (article 6-32).

## Chapter Five

### Financial Market Infrastructures

- Article 5-1** FMI will need to hold additional capital over and above Risk Based Capital charge required from its activities, in order to cover the costs of a voluntary cessation of business or restructuring/recovery.
- Article 5-2** FMI should draw up a plan as to how their systemically important business processes are to be terminated or recovered in an orderly way in the event of a voluntary cessation of business or recovery event. The orderly wind down or recovery plan must take into account the period of time required for the participants to sign up to an alternative FMI, if required.
- Article 5-3** The additional capital held by an FMI must suffice to implement the orderly wind down or recovery plan and must at least be sufficient to cover ongoing operating expenditure for six months. This additional capital requirement must be met with CET 1 capital.
- Article 5-4** Where a licensed person has been active for less than six months, it may use business projections of operating expenditure, subject to the condition that historical data is used as soon as it becomes available.
- Article 5-5** The additional capital requirement must be used to fund assets that can be readily liquidated in the event of an orderly wind down or recovery to provide for at least six months of operating expenditure. These assets should be highly marketable and able to be liquidated with minimal losses. Alternatively, these assets should have maturities that are aligned to the maturity profile of the expected operations expenses during the recovery or wind down period. In addition, the licensed person may acquire bank guarantees or asset swap arrangements in order to ensure that these assets can be used to readily generate cash.

## Chapter Six

### Capital Requirements for Islamic Financing and Investment Instruments

<b>Article 6-1</b>	This appendix covers the capital requirements for Islamic financing and investment instruments executed by all <u>licensed persons</u> .
<b>Article 6-2</b>	AUM and CIS are out of the scope of this appendix, since both are covered in chapter 4/H: Assets Under Management.
<b>Article 6-3</b>	<p>Capital requirements shall be determined based on the type of the instrument:</p> <ol style="list-style-type: none"> <li>Wakalah transactions.</li> <li>Investment with customers through Mushārah and Mudārah.</li> <li>Ijārah and Ijārah Muntahia Bittamlik (IMB) transactions.</li> <li>Istisnā` transactions.</li> </ol> <p>For other credit risk exposures with customers (e.g. Murabaha or investment in sukuk recorded at amortized cost), it should be included into one of the underlying portfolios according to the customer characteristics (article 4-66). For instance, investment in sukuk (i.e. at amortized cost) shall be classified as credit risk exposure based on the type of the issuer (e.g. sukuk issued by sovereigns should be classified as exposure to sovereigns).</p>
<b>Article 6-4</b>	Investments/financings are characterized by special features of the assets underlying these transactions and the nature of contractual relationship with customers in different cases. In some cases, these assets are subject to market/price risk due to the <u>licensed person's</u> exposure to the price of the underlying assets, in addition to credit risks arising out of these transactions.
<b>Article 6-5</b>	Receivables resulting from the investment and financing transactions with customers shall be treated and reported according to the <u>Credit Quality Grade</u> of the customer in accordance with chapter 4/D: Credit Risk.
<b>A. Capital Requirements for Wakalah Transactions:</b>	
<b>Article 6-6</b>	For Wakālah transactions, <u>licensed persons</u> will need to determine capital requirements based on the nature of the transaction and underlying assets, and classify the exposure into one of the standard risk portfolios.
<b>Article 6-7</b>	If Wakālah is invested, for instance, by holding deposits with banks (i.e. placements), it should be treated and reported as Claims on Banks, and capital requirements shall be calculated and reported in accordance with chapter 4/D: Credit Risk. (Refer to Appendix 4: Example 9).

**Article 6-8** If such transactions are exposed to market risk (e.g. investment in commodities), then capital requirements for market risk will be determined and reported in accordance with chapter 4/A: Market Risk. (Refer to Appendix 4: Example 4).

**Article 6-9** If the licensed person cannot assign Wakālah based transactions to any of the standard portfolios, then it will be assigned with a risk charge of 60%, and it should be reported under “High Risk Exposure” category.

**B. Capital Requirements for Musharakah and Mudarabah Transactions:**

**Article 6-10** These investments are represented in specialized financing/investment transactions carried out with customers on the basis of participation in profit and loss (in Mudarabah transactions, Mudarib will participate in losses in limited cases, such as infringement). They are not executed for the purpose of trading or liquidity, but for the purposes of obtaining a return from medium- and long-term financing, such as Musharakah, Diminishing Musharakah and Mudarabah (unrestricted or restricted).

**Article 6-11** In event the assets of these transactions are among the assets that are subject to market risk requirements, such as commodities and equity instruments, they shall be treated and reported in accordance with chapter 4/A: Market Risk (Refer to Appendix 4: Example 4).

**Article 6-12** A Risk charge of 60% shall be applied for investments in private and commercial projects, net of the determined provisions, and it should be reported under “High Risk Exposure” category (Refer to Appendix 4: Example 10).

**Article 6-13** In event of the licensed person having a joint ownership (i.e. Musharakah) with a customer in real estate or movable assets with the existence of a sub-Ijārah contract to a third party (Musharakah with a sub- Ijārah contract) or with the existence of sub-Murabaha contract for sale to a third party (Musharakah with sub- Murabaha contract), risk charges shall be applied and reported according to the credit quality grade of the third party (the lessee or a buyer) in accordance with chapter 4/D: Credit Risk.

**Article 6-14** In case of diminishing Musharakah with a customer in tangible fixed assets (such as real estate, cars, machinery, etc.) with the existence of a sub-Ijārah contract to a third party or with the existence of sub-Murabaha contract for sale to a third party, risk charge shall be applied and reported according to the credit quality grade of the counterparty or the lessee in accordance with chapter 4/D: Credit Risk. As for the residual value of the asset (if exists, for sub-Ijārah contract only), it will be given a risk charge of 30% (Refer to Appendix 4: Example 10) and it will be reported under investment in real estate “Chapter 4/C: Investment Risk”.

<b>Article 6-15</b>	<p>However, if the exposure under the diminishing Musharakah contract consists of working capital finance in the customer's business venture, the <u>licensed person</u> shall measure its capital requirement based on a risk charge of 60%, and it should be reported under "High Risk Exposure" category. (Refer to Appendix 4: Example 10).</p>
<b>C. Capital Requirements for Ijārah and Ijārah Muntahia Bittamlik (IMB):</b>	
<b>C.1. Operating lease (Ijārah): (Refer to Appendix 4: Example 11)</b>	
<b>Article 6-16</b>	<p>Receivables resulting from Operating Ijārah transactions, be they for real estate assets or for movables, shall be risk-charged and reported according to the customer's credit grade quality in accordance with chapter 4/D: Credit Risk.</p>
<b>Article 6-17</b>	<p>Assets (e.g. Real estate properties, movable assets) in operating lease are subject to risk-charge of 30%, and it will be reported under investment in real estate "Chapter 4/C: Investment Risk".</p>
<b>C.2. Ijārah Muntahia Bittamlik (IMB): (Refer to Appendix 4: Example 11)</b>	
<b>C.2.A. Prior to the signing of the lease contract (Ijārah Contract):</b>	
<b>Article 6-18</b>	<p>Assets (real estate and movable assets) available for lease are exposed to credit risk in event a binding PL (i.e. Promise to Lease) contract exists with the right of the <u>licensed person</u> to recourse to the HJ (i.e. Hamesh al Jediah), and the right to seek indemnification against any losses in the lease or sale of the asset to a third-party. In such cases, the exposure will be calculated according to the acquisition cost of the asset less (1) market value of asset fulfilling the function of collateral (net of any haircuts), and (2) any HJ. Such exposures shall be risk-charged and reported based on the <u>credit quality grade</u> of the customer (lessee) in accordance with chapter 4/D: Credit Risk.</p>
<b>Article 6-19</b>	<p>However, in the absence of the <u>licensed person's</u> right to recourse to the HJ margin or to obtain indemnification against losses, the value of the asset shall be treated as in case of a non-binding promise and shall be subject to the market risk (prices) according to article 6-20.</p>
<b>Article 6-20</b>	<p>Assets available for lease with a non-binding PL, shall be subject to risk charge of 30% until the lessee takes possession of the asset, and it will be reported under investment in real estate "Chapter 4/C: Investment Risk".</p>

**C.2.B. Upon signing the lease contract (Ijārah contract):**

**Article 6-21** Upon consigning an Ijārah contract and the commencement of the Ijārah rental instalment from the lessee, the credit risk capital requirements shall be calculated based on the total estimated value of lease receivables for the full term of the contract, minus the leased assets residual value, using a risk-charge based on the credit quality grade of the lessee, and it should be reported in accordance to chapter 4/D: Credit Risk.

**Article 6-22** The residual value, if exists, of the assets shall be subject to risk-charge of 30%, and it will be reported under investment in real estate “Chapter 4/C: Investment Risk”.

**D. Capital Requirements for Istisnā` and parallel Istisnā`:  
(Refer to Appendix 4: Example 12)**

**Article 6-23** A licensed person can play different roles while engaging in the contract of Istisnā`, such that he may:

- a. Act as a seller (al-sani’) in Istisnā` contract.
- b. Act as a buyer (al-mustasni’) in Istisnā` contract.

**Article 6-24** In addition to the above, there are two different types of exposures that may arise in Istisnā` financing:

- a. Exposure to the customer [Full Recourse Istisnā`].
- b. Exposure to asset (i.e. exposure to the cash flows from the asset) [Limited and Non-Recourse Istisnā`].

**D.1. Capital requirements when acting as a Seller (al-sani’) in Istisnā` contract:**

**D.1.A. Exposure to Customer:**

**Article 6-25** The receivable amount generated from selling of an asset in a parallel Istisnā` contract, with full recourse/exposure to the customer (ultimate buyer), shall be assigned a risk-charge and reported based on the credit quality grade of the customer in accordance with chapter 4/D: Credit Risk.

**Article 6-26** An additional risk-charge of 3% needs to be applied on an Istisnā` (with Parallel Istisnā`) where certain provisions in the Parallel Istisnā` contract allow the seller (i.e. the third party/contractor) to increase or vary its selling price to the licensed person, under unusual circumstances.

**Article 6-27** In case a parallel Istisnā` contract is not executed, a risk-charge of 18% shall be applied to meet the credit risk and the market risk of changing prices, and it should be reported in accordance with chapter 4/I: Other Exposures.

**D.1.B. Exposure to Asset:**

**Article 6-28**

When the project (i.e. the underlying asset) is rated by an ECAI, the risk-charge, based on the credit rating of the project, is applied to calculate and report the credit risk capital requirement for Istisnā` (with or without parallel Istisnā`) transactions with partial or total reliance on the amount of revenues of the project, as per the table below:

Project External Credit Rating	BBB- or better	BB+ or BB	BB- or B+	B to C-
Risk-charges	10.5%	13.5%	17.25%	37.5%

**Article 6-29**

The Istisnā` financing structure with partial or total reliance in collection of the price on revenues of the project must satisfy the following conditions to qualify for the risk-charges mentioned in the previous paragraph:

- a. Segregation of the project's liabilities from the balance sheet of the Istisnā` ultimate buyer (project sponsor) from a commercial and accounting perspective which is generally achieved by having the Istisnā` contract made with a special-purpose vehicle (SPV) set up to acquire and operate the asset/project concerned.
- b. The ultimate buyer is dependent on the income received from the assets acquired/projects to pay the purchase price.
- c. The contractual obligations give the manufacturer/constructor/licensed person a substantial degree of control over the asset and the income it generates – for example, under the BOT arrangement where the manufacturer builds a highway and collects tolls for a specified period as a consideration for the selling price.
- d. The primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the ultimate buyer.

If these conditions have not been satisfied, the exposure will be deemed as being an exposure on the customer and risk-charge shall be calculated as in cases of Istisnā` transactions with full recourse (Section D.1.A above).

**D.2. Capital requirements when acting as a Buyer (al-mustasni')  
in Istisnā` contract:**

**D.2.A. Exposure to Customer:**

**Article 6-30**

The receivable amount generated from selling of an asset based on a parallel Istisnā` contract with full recourse to the customer (ultimate buyer) shall be assigned a risk-charge and reported based on the credit quality grade of the customer in accordance with chapter 4/D: Credit Risk.

**Article 6-31**

An additional risk-charge of 3% needs to be applied on an Istisnā` (with Parallel Istisnā`) where certain provisions in the Parallel Istisnā` contract allow the seller (i.e. the third party/contractor) to increase or vary its selling price to the licensed person, under unusual circumstances. Any variations in a parallel Istisnā` contract that are reflected in the corresponding Istisnā` contract which effectively transfers the whole of the price risk to a parallel Istisnā` customer (ultimate buyer) is also eligible for this treatment.

**Article 6-32**

In case a parallel Istisnā` contract is not executed, a credit risk charge does not apply. In such cases, the licensed person is exposed to WIP inventory risk and should be risk-charge of 18% and it should be reported in accordance with chapter 4/I: Other Exposures.

**D.2.B. Exposure to Asset:**

**Article 6-33**

When the project is rated by an ECAI, the risk-charge based on the credit rating of the project is applied as per table in article 6-28 above.

**Article 6-34**

The Istisnā` financing structure must satisfy the conditions set forth in article 6-29 above in order to qualify for the risk-charges mentioned in article 6-28 above.

**D.3. General Rules**



- Article 6-35** The capital requirement is to be calculated on the receivable amount, net of specific provisions and amount of eligible collateral.
- Article 6-36** Any portion of an Istisnā` contract covered by an advance payment shall carry a risk-charge of 0%, or the amount of the advanced payment shall be offset against the total amount receivable or amounts owing from progress billings.
- Article 6-37** The credit risk-charge is to be applied from the date when the manufacturing or construction process commences and until the selling price is fully settled by the licensed person, either in stages and/or on the maturity of the Istisnā` contract, which is upon delivery of the manufactured asset to the Istisnā` ultimate buyer.
- Article 6-38** It is not allowed to apply netting of credit exposure in an Istisnā` contract and credit exposure in a parallel Istisnā` contract, because an obligation under one contract does not discharge an obligation to perform under the other contract.

**DISCLAIMER:**

This “translation” of the Bylaws of the Capital Markets Authority from Arabic into English is provided solely for reference. No translation can exactly reflect every aspect of an original text and accordingly this “translation” may be used for guidance but not for legal purposes. Only the Arabic original shall be considered for legal proceedings and legal actions before the competent courts of jurisdiction and in any arbitration mechanism agreed upon by contracting parties to any transaction made under the Law and the Bylaws thereof. The Capital Markets Authority shall not be responsible for any mistake, error and/or misinterpretation made or given by any party based on that party’s interpretation of the Law and the Bylaws whether arising from a reading of the Arabic text or, specifically in the context of this document, the English “translation”. The original Arabic versions, as approved and accordingly published by the Authority, shall constitute the only source of the provisions and regulations of the Law and its Bylaws.

**Appendix 1**  
**Mapping Notations**

**Table 11:**  
**Mapping notations used by individual ECAs for sovereigns**

Sovereign Credit Quality Grades	Risk Charge (%)	S&P	Moody's	Fitch
1	0%	AAA	Aaa	AAA
		AA+	Aa1	AA+
		AA	Aa2	AA
		AA-	Aa3	AA-
2	3%	A+	A1	A+
		A	A2	A
		A-	A3	A-
3	7.5%	BBB+	Baa1	BBB+
		BBB	Baa2	BBB
		BBB-	Baa3	BBB-
4	15%	BB+	Ba1	BB+
		BB	Ba2	BB
		BB-	Ba3	BB-
5	15%	B+	B1	B+
		B	B2	B
		B-	B3	B-
6	22.5%	CCC+	Caa1	CCC+
		CCC	Caa2	CCC
		CCC-	Caa3	CCC-
		CC	Ca	CC
		C	C	C
		D		D
Unrated	15%			

**Table 12:**  
**Mapping notations used by individual ECAs for banks**

Bank Credit Quality Grade	Risk Charge for exposures	S & P	Moody's	Fitch
1	3%	AAA	Aaa	AAA
		AA+	Aa1	AA+
		AA	Aa2	AA
		AA-	Aa3	AA-
2	7.5%	A+	A1	A+
		A	A2	A
		A-	A3	A-
3	7.5%	BBB+	Baa1	BBB+
		BBB	Baa2	BBB
		BBB-	Baa3	BBB-
4	15%	BB+	Ba1	BB+
		BB	Ba2	BB
		BB-	Ba3	BB-
5	15%	B+	B1	B+
		B	B2	B
		B-	B3	B-
6	22.5%	CCC+	Caa1	CCC+
		CCC	Caa2	CCC
		CCC-	Caa3	CCC-
		CC	Ca	CC
		C	C	C
		D		D
Unrated	7.5%			

**Table 13:**  
**Mapping notations used by individual ECAs for Corporates**

Corporate Credit Quality Grades	Risk Charge (%)	S & P	Moody's	Fitch
1	3%	AAA	Aaa	AAA
		AA+	Aa1	AA+
		AA	Aa2	AA
		AA-	Aa3	AA-
2	7.5%	A+	A1	A+
		A	A2	A
		A-	A3	A-
3	15%	BBB+	Baa1	BBB+
		BBB	Baa2	BBB
		BBB-	Baa3	BBB-
4	15%	BB+	Ba1	BB+
		BB	Ba2	BB
		BB-	Ba3	BB-
5	22.5%	B+	B1	B+
		B	B2	B
		B-	B3	B-
6	22.5%	CCC+	Caa1	CCC+
		CCC	Caa2	CCC
		CCC-	Caa3	CCC-
		CC	Ca	CC
		C	C	C
		D		D
Unrated	15%			

## Appendix 2

### Recognized Exchanges

For recognition as eligible CRM, equities should be listed on the following exchanges:

### **The eligible GCC Stock Exchanges**

- a. Boursa Kuwait
- b. Abu Dhabi Securities Exchange (ADSE)
- c. Dubai Financial Market (DFM)
- d. NASDAQ Dubai
- e. Saudi Stock Exchange (Tadawul)
- f. Qatar Exchange
- g. Muscat Securities Market (MSM)
- h. Bahrain Stock Exchange (BSE)

### **The eligible International Stock Exchanges**

- a. New York Stock Exchange (NYSE)
- b. NASDAQ
- c. Tokyo Stock Exchange (TSE)
- d. London Stock Exchange Group (LSE)
- e. Netherlands EuroNext
- f. Hong Kong Stock Exchange (HKSE)
- g. Shanghai Stock Exchange (SSE)
- h. Toronto Stock Exchange (TSX)
- i. Frankfurt Stock Exchange
- j. Australian Securities Exchange (ASX)
- k. Athena Stock Exchange (ATHEX)

Licensed persons must consult with the Capital Markets Authority to use securities listed on any other exchange as an eligible CRM.



## **Appendix 3**

### **Detailed Definition of Business Lines**

**Table 14**

Business lines	Major business segments	Activity Groups
Brokerage	Brokerage	Execution and full service
Trading	Sales	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage
	Market making	
	Proprietary Positions	
	Treasury	
Investment Portfolio / CIS Management & Managing any Client Asset	Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open
	Non-Discretionary Fund Management	Pooled, segregated, retail, institution, closed, open
Custodian	Custody	Escrow, Depository Receipts, Securities lending (Customers), Corporate actions
	Corporate Agency	Issuer and paying agents
	Corporate Trust	
Payment and settlement, Clearing and Market Making	External Clients	Payments and collections, fund transfer, clearing and settlement
Providing Financing	Retail, Corporate, Financial Institutions	

## Appendix 4

### Calculation Examples

### Example 1: Capital Treatment of Equity Investments in Financial Institutions

This example illustrates the Capital treatment of Investments in the capital of financial institutions. A licensed person undertakes the following investments in financial institutions (common shares) which are subject to deductions:

Investment	Stake	Amount (KD)
Financial entity 1 (Equity)	10%	15
Financial entity 2 (Equity)	15%	25
Financial entity 3 (Equity)	25%	30
Total Inv. in FIs Equity		70

Investing Licensed person's Share Capital(CET1)	:	100
10% of the licensed person's Share Capital (CET1)	:	10
Total licensed person's investment in FI's equity	:	70
Excess of 10% share capital (Equity Inv.)	:	60
Total of Individual excesses (Deducted from CET1 capital)	:	60
Remaining Investments (Equity)	:	10
Amount subject to risk charge of 37.5%	:	10

### Example 2: Calculating specific and general market risk charge on interest rate position

A licensed person has the following given positions:

- a. Qualifying (PSE) bond: 15,000,000 (market value), remaining maturity 8 years, coupon 8%.
- b. Government bond: 50,000,000 (market value), remaining maturity 2 months, coupon 7%, rated AA+ (corresponding to CQG 2).
- c. Interest rate swap: 80,000,000 - Licensed person receives floating rate interest and pays fixed, next interest reset after 12 months, market value of the underlying security is 400,000,000 - remaining life of the underlying security is 10 years, remaining life of swap is 8 years (assumes the current interest rate is identical to the one the swap is based on).
- d. Long position in interest rate future: 65,000,000 - delivery date after 6 months, market value of the underlying government security is 100,000,000 - life of underlying government security is 3.5 years (assumes the current interest rate is identical to the one on which the swap is based), rated AA- (corresponding to CQG 2).

The licensed person would calculate specific risk as shown below:

Category of Bond (Issuer)	Credit Quality Grades (CQG)	Remaining Maturity	Risk Charge	Current Market Value (in '000s)	Capital charge ('000s)
			A	B	A x B=C
Government	1	N/A	0.00%		0.0
	2 & 3	6 months or less	0.25%	50,000	125
		Over 6 to 24 months	1.00%		0.0
		Over 24 months	1.60%	100,000	800
	4, 5 & 6	N/A	12.00%		0.0
Fully Guaranteed by qualifying PSEs over 6 to 24 months over 24 months		6 months or less	0.25%		0.0
		1.00%		0.0	
		1.60%	15,000	240	
Bonds rated below 4 (Other issuers) and Other Bonds		N/A	12.00%	400,000	48,000
<b>Total Specific Risk Capital requirement</b>					<b>49,165</b>

The licensed person would calculate general risk as shown below:

Time-band	Position for instruments:				Gross position ('000s)	Risk charge (%)	Capital Charge ('000s)
	(in '000s)						
	A	B	C	D			
up to 1 month						0	
Over 1 up to 3 months		50,000			50,000	0.2	100
Over 3 up to 6 months				-65,000	65,000	0.4	260
Over 6 months up to 1 year			80,000		80,000	0.7	560
Over 1 up to 1.9 years						1.25	
Over 1.9 up to 2.8 years						1.75	
Over 2.8 up to 3.6 years				65,000	65,000	2.25	1,463
Over 3.6 up to 4.3 years						2.75	
Over 4.3 up to 5.7 years						3.25	
Over 5.7 up to 7.3 years						3.75	
Over 7.3 up to 9.3 years	15,000				15,000	4.5	675
Over 9.3 up to 10.6 years			-80,000		80,000	5.25	4,200
Over 10.6 up to 12 years						6	
Over 12 up to 20 years						8	
Over 20 years						12.5	
Total	15,000	50,000	-	-	355,000		7,258
Total General Risk capital requirement							7,258

### Example 3: Calculation of capital charge for foreign exchange risk

If the licensed person holds the following net open positions in foreign currencies:

Currency	Net Open Position
USD	4,000
GBP	2,000
Euro	(1,500)
Swiss francs	(2,000)
Japanese yen	500

- Step (1) is to calculate the sum of the net open long positions, i.e.  $[4000+2000+500] = 6,500$
- Step (2) is to calculate the sum of the net open short positions on absolute basis, i.e.  $- [1,500+2,000] = 3,500$
- Step (3) is to calculate the maximum of the open positions calculated in Step 1 and Step 2 = 6,500

Currency	Net Spot Position	Net Forward Position	Guarantee and similar instruments	Net Unearned Income / Expenses	Net Open Position E=A+B+C+D
	A	B	C	D	E
US dollar	4,000				4,000
UK pound	2,000				2,000
Euro	(1,500)				(1,500)
Swiss franc	(2,000)				(2,000)
Japanese yen	500				500
Others - Long					-
Others - Short					-
Gold					-
Sum of net open long position				F	6,500
Sum of net open short position (expressed in absolute value)				G	3,500
Greater of box F and box G				H	6,500
Absolute value of open position in gold				I	-
Sum of box H and box I				J	6,500
Capital charge ( 8% of box J )				K	520

- The capital requirement for FX risk is calculated as = KD 520

**Example 4:**  
**Calculating capital charge for commodities risk**

A licensed person has the following given positions in one commodity.

Position	Amount KD	Maturity
Long position	60,000	2 months
Short position	50,000	7 months
Long position	50,000	9 months
Short position	40,000	1 year

The capital charge for commodities risk in respect of the above positions will be calculated as follows:

	Gross position KD	Net position KD	Capital charge KD
3% capital charge on gross position	200,000	-	6,000
15% capital charge on net position	-	20,000	3,000
Total capital charge			9,000



**Example 5:**  
**Calculation of capital charge for options**

If the licensed person holds 100 shares with a market value of KD 12 each and the licensed person has an equivalent put option with a strike price of KD13, the capital charge will be calculated as follows:

- 1- Step (1) is to calculate the market value of the underlying instrument which is KD 1,200 (i.e. 100 shares multiplied by the market value of KD 12 per share).
- 2- Step (2) is to determine the sum of specific and general market risk charges applicable to the underlying which is 16% (i.e. 8% of specific risk charge plus 8% of general risk charge).
- 3- Step (3) is to calculate the amount the option is in the money which is KD100 i.e.  $(13-12) \times 100 = \text{KD } 100$ .
- 4- Step (4) is to calculate the capital charge which is  $[(\text{KD } 1,200 \times 16\%) - (\text{KD } 100)] = \text{KD } 92$ .

### Example 6: Operational Risk Charge Calculation

This example illustrates the measurement of operational risk capital requirement, which is set out in Operational risk section.

Consider, a licensed person has net operating income from the following 3 business lines.

Business Line	Annual Gross Income Reporting Year	Annual Gross Income Year (-I)	Annual Gross Income Year (-II)
Trading	105	100	95
Asset Management	200	(90)	(180)
Brokerage services	90	75	(60)

Step (1) – Applying beta factor to arrive at the capital charge for each business line for each year

Business Line	Beta Factor (%)
Trading	18%
Asset Management	12%
Brokerage services	24%

Business Line	Capital Charge Reporting Year	Capital Charge Year (-I)	Capital Charge Year (-II)
Trading	18.9	18	17.1
Asset Management	24	(10.8)	(21.6)
Brokerage services	21.6	18	(14.4)
Max [sum,0]	64.5	25.2	0

Step (2) – Average charge across 3 years

The operational risk capital charge is calculated as average across 3 years multiplied by 1.875

$$= 1.875 * [(64.5 + 25.2 + 0) / 3]$$

$$\text{Operational risk charge} = 56.063$$

### Example 7: Counterparty Credit Risk (CCR) Calculation

This example illustrates the CCR treatment for Derivative transactions, which is set out in Counterparty Credit Risk' section.

A Licensed person enters into the following three OTC Derivative transactions, with three different counterparties, which are subject to CCR treatment.

#	Type	Credit Rating (S&P)	Risk Charge (r)	Notional Amount	MTM (R <sub>C</sub> )	Eligible Collateral (CA)	Residual Maturity (Years)	Exposure of Default (EAD)
1	FX	AA	3%	10	5	1	1	20
2	IR	BB	15%	10	10	0	1	10
3	Equity Option	CCC	15%	10	3	0	1	25

Counterparty Credit Risk is calculated as per the formula below:

$$\text{CCR capital charge} = \{[(R_C + A_{\text{Net}}) - CA] \times \text{rw charge}\%$$

#### Transaction 1:

$$\{(R_C + A_{\text{Net}}) - CA\} \times \text{rw charge}\% = \{5 + (10 \times 1\%) - 1\} \times 3\% = 0.12$$

#### Transaction 2:

$$\{(R_C + A_{\text{Net}}) - CA\} \times \text{rw charge}\% = \{10 + (10 \times 0\%) - 0\} \times 15\% = 1.5$$

#### Transaction 3:

$$\{(R_C + A_{\text{Net}}) - CA\} \times \text{rw charge}\% = \{3 + (10 \times 6\%) - 0\} \times 15\% = 0.54$$

$$\text{CCR Capital Charge (prior to CVA)} = 2.163$$

$$\text{CVA Capital Charge} = 20\% \text{ of CCR Capital Charge} = 20\% \times 2.163 = 0.433$$

### Example 8: Treatment of bilateral netting agreement

This example illustrates the treatment of bilateral netting agreements.

Assumed a Licensed person has entered into a repo style transaction wherein it receives as collateral 100 shares of current market value KD 100 which are listed on main index at the stock exchange and provides USD 330 (assuming an exchange rate of KD 1 = USD 3.3).

In order to calculate the net exposure that the licensed person is exposed after risk mitigation a licensed person will apply formula mentioned in article 4-178 as follows:

$$E^* = \max \{0, [(E) - (C)] + (E_s \times H_s) + (E_{FX} \times H_{FX})\}$$

Where:

$E^*$  = the exposure value after risk mitigation

$E$  = current value of the exposure = KD 100 (Equivalent to USD 330)

$C$  = the value of the collateral received = KD 100 (Current market value)

$E_s$  = absolute value of the net position in a given security = KD 100

$H_s$  = haircut appropriate to  $E_s$  = 15% (as per table 8 for main index securities)

$E_{FX}$  = absolute value of the net position in a currency different from the settlement currency = KD 100 (Equivalent to USD 330)

$H_{FX}$  = haircut appropriate for currency mismatch (8%)

$$E^* = \max \{0, [(100 - 100) + (100 \times 15\%) + (100 \times 8\%)]\}$$

$$E^* = \max \{0, [0 + 15 + 8]\}$$

$$E^* = \max \{0, 23\}$$

$$E^* = \text{KD } 23$$

### **Example 9: Treatment of Wakalah Contracts**

This example illustrates the treatment of Wakalah Contracts:

Assume a Licensed person has entered into a Wakalah transaction wherein it deposited 10 million KWD as placement with a bank who's externally rated by S&P as A+.

1. Exposure = 10,000,000
2. Risk-charge for bank rated A+ (credit quality grade = 2) = 7.5%
3. Capital requirements =  $10,000,000 * 7.5\% = \text{KWD } 750,000$

### Example 10: Treatment of Musharakah/Mudarabah

- a. This example illustrates the treatment of Musharakah/Mudarabah Contracts:  
Assume a Licensed person has entered into a Musharakah contract wherein he invested 35 million KWD to buy a hotel that worth KWD 60 million (i.e. client invested 25 million). However, due to expected market conditions, the licensed person has set aside 2 million as provision to cover any expected decrease in the value of the hotel.
- i. Investment should be categorized as “investment in commercial projects”
  - ii. Risk-Charge = 60%
  - iii. Exposure =  $35 - 2 = 33$  Million.
  - iv. Capital Requirements =  $33,000,000 * 60\% = 19,800,000$
- b. This example illustrates the treatment of Diminishing Musharakah with sub-Ijārah contract:  
Assume a licensed person has entered into diminishing Musharakah contract wherein he invested KWD 10 million in real estate. They (licensed person and the client) have entered into sub-Ijārah contract with corporate “third party” that is unrated. Currently, The residual value of the real estate equals to 7 million.
- i. Credit Risk:
    - 1.1 Exposure = 10,000,000.
    - 1.2 Risk-charge for unrated corporate = 15%
    - 1.3 Capital requirements =  $10,000,000 * 15\% = \text{KWD } 1,500,000$
  - ii. Residual Value:
    - 1.1 Exposure = 7,000,000
    - 1.2 Risk charge = 30%
    - 1.3 Capital Requirement =  $7,000,000 * 30\% = 2,100,000$
  - iii. Total Capital Requirements =  $1,500,000 + 2,100,000 = 3,600,000$
- c. This example illustrates the treatment of Diminishing Musharakah Contracts for financing working capital:  
Assume a licensed person has entered into diminishing Musharakah contract wherein he invested 2 million to finance the working capital of the clients’ business venture.
1. Exposure = 2,000,000
  2. Risk Charge = 60%
  3. Capital Requirements =  $2,000,000 * 60\% = 1,200,000$

### Example 11: Treatment of Ijārah and Ijārah Muntahia Bittamlik (IMB):

- A. This example illustrates the treatment of Operating Lease (Ijarah) Contracts:  
Assume a licensed person has entered into operating lease contract to lease a commercial real estate that worth 2.5 million to a corporate (lessee) that is unrated, with an annual rent that is equal to KWD 100,000. The licensed person balance sheet shows that the current book value of the CRE equal to 2.3 million, and there is lease receivable that is equal to KWD 55,000
1. Credit Risk:
    - 1.1 Exposure = 55,000
    - 1.2 Risk-Charge = Risk-charge for unrated corporate = 15%
    - 1.3 Capital Requirements =  $55,000 * 15\% = 8,250$
  2. Price Risk:
    - 2.1 Exposure = 2,300,000
    - 2.2 Risk-Charge = 30%
    - 2.3 Capital Requirements =  $2,300,000 * 30\% = 690,000$
  3. Total capital requirements =  $8,250 + 690,000 = 698,250$
- B. This example illustrates the treatment of Ijārah Muntahia Bittamlik (IMB) Contracts:  
Assume a licensed person has entered into IMB contract with a corporate (lessee) that is unrated. The value of lease contract is 2.3 million on a real estate that has a residual value of 2 million.
1. Credit Risk:
    - 1.1 Exposure = Total estimated value of lease receivables – leased asset residual value  
Exposure =  $2,300,000 - 2,000,000 = 300,000$
    - 1.2 Risk Charge = Risk-charge for unrated corporate = 15%
    - 1.3 Capital Requirements =  $300,000 * 15\% = 45,000$
  2. Price Risk:
    - 2.1 Exposure = Residual value of the leased asset = 2,000,000
    - 2.2 Risk Charge = 30%
    - 2.3 Capital Requirements =  $2,000,000 * 30\% = 600,000$
  3. Total Capital Requirements =  $45,000 + 600,000 = 645,000$

**Example 12:**  
**Treatment of Istisnā` and parallel Istisnā`:**

A. This example illustrates the treatment when acting as a **Seller**:

Assume a licensed person has entered into Istisnā` contract to build factory as a seller without executing parallel Istisnā`. The value of contract is 5.7 million, and the licensed person has Istisnā` receivables equal to 500,000. The licensed person had received 150,000 as an advance payment.

Exposure = Istisnā` receivables – advance payment = 500,000 – 150,000 = 350,000

Risk Charge = 18% (for Istisnā` contracts and without parallel Istisnā` contracts)

Capital Requirements = 350,000 \* 18% = 63,000

B. This example illustrates the treatment when acting as a **Buyer**:

Assume a licensed person has entered into Istisnā` contract to build factory as a buyer without executing parallel Istisnā`. The value of contract is 5.7 million, and the licensed person has Istisnā` receivables equal to 500,000.

Exposure = Istisnā` receivables = 500,000

Risk Charge = 30% (for Istisnā` contracts and without parallel Istisnā` contracts)

Capital Requirements = 500,000 \* 30% = 150,000



**Appendix 5**  
**Footnotes Clarifications**

1. Any entity operating under the legal form of “Branch of foreign company” as per its license application as defined in “Appendix 5 Application for Securities Activities License” of Module 5 of CMA Executive Bylaws
2. A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of the consolidated licensed person.
3. Investments in entities that are outside of the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk capital charge of the licensed person.
4. Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the licensed person substantially equivalent to the loss in value of the direct holding.
5. Only General Risk Charge will be applicable for Loans and Borrowings/Deposits with netting allowed. These positions should use effective outstanding/nominal amounts as proxy for market value of the debt position for purpose of calculation of capital charges.
6. Any instance of an interest rate being reset-either due to maturities or floating interest rate resets-is called a repricing. The date on which it occurs is called the repricing date.
7. The leg representing the time to expiry of the future or forward should, however, be reported.
8. This includes the delta-equivalent value of options. The delta equivalent of the legs arising out of the treatment of caps and floors can also be offset against each other under the rules laid down in this article.
9. The separate legs of different swaps may also be “matched” subject to the same conditions.
10. Any foreign exchange risk arising out of these positions has to be accounted for as per section Foreign Exchange Risk below.
11. Business Lines and activity categories are described in Appendix 3.
12. Investment grade rating, for long term, refers to a rating of Baa3 (Moody's), BBB- (S&P and Fitch) or better. Investment grade rating, for short term, refers to a rating of P-3 (Moody's), A-3 (S&P), F3 (Fitch) or better.
13. For the purpose of this framework, recognized exchanges are listed in Appendix 2: Recognized Exchanges.
14. Includes PSEs which attracts 0% risk charge.
15. Long settlement transaction means a transaction where a counterparty undertakes to deliver a security, a commodity, or a foreign currency amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date that is contractually specified as more than the lower of the market standard for this particular transaction and five business days after the date on which the licensed person enters into the transaction.

16. A Gross equals the sum of individual add-on amounts (calculated by multiplying the notional principal amount by the appropriate add-on factors of all transactions subject to legally enforceable netting agreements with one counterparty)
17. The Capital Markets Authority permits a choice of calculating the NGR on a counterparty by counterparty or on an aggregate basis level for all transactions subject to legally enforceable netting agreements. However, the method chosen by a licensed person is to be used consistently. Under the aggregate approach, net negative current exposures to individual counterparties cannot be used to offset net positive current exposures of another counterparty i.e. for each counterparty the net current exposure used in calculating the NGR is the maximum of the net replacement cost or zero. Note that under the aggregate approach, the NGR is to be applied individually to each legally enforceable netting agreement so that the credit equivalent amount will be assigned to the appropriate counterparty risk charge category.
18. As per the approach for Credit Risk under these Guidelines as per article 4-63 to 4-93.
19. For the purposes of this section, the treatment of netting also applies to exchange traded derivatives.
20. The risk reduction in case the margin period of risk is greater than 5 days are as follows: 6 days - scalar=0.77; 7 days – scalar = 0.84; 8 days – scalar = 0.89; 9 days – scalar = 0.95; 10 days or higher – scalar = 1.
21. Where the entity holding such assets or collateral is the CCP, a risk charge of 0.3% applies to collateral included in the definition of trade exposures. The relevant risk charge of the CCP will apply to assets or collateral posted for other purposes.
22. In this article, the word “custodian” may include a trustee, agent, pledgee, secured creditor or any other person that holds property in a way that does not give such person a beneficial interest in such property and will not result in such property being subject to legally-enforceable exposures by such persons creditors, or to a court-ordered stay of the return of such property, should such person become insolvent or bankrupt.
23. Under this approach the 0.3% risk charge on trade exposures given by Article 4-154 does not apply as it is included in the equation in Article 4-166.
24. Securities Financing Transactions (SFTs) are transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on the market valuations and the transactions are often subject to margin agreements.
25. The holding period for the haircuts will depend, as in other repo-style transactions, on the frequency of margining.

**Appendix 6**  
**Regulations' Templates**

**Summary**

No	Summary	Table	Amount
A	Available (Eligible) Regulatory Capital	1	
B	Required Regulatory Capital (Sum)		
B1	Market Risk Capital Requirement	2	
B2	Operational Risk Capital Requirement	3	
B3	Investment Risk Capital Requirement	4	
B4	Credit Risk Capital Requirement	5	
B5	Counterparty Credit Risk Capital Requirement	6	
B6	AUM Capital Requirement	7	
B7	Other Exposures Capital Requirement	8	
B8	FMI "Winding down" Capital Requirement	9	
	Capital Adequacy % (A / B)		

**Regulatory Capital**  
**Table 1**  
**Regulatory Capital Calculation**  
**For the financial period / /**

KD '000s

Capital Components	CET 1	AT 1	T2
	A	B	C
Common Shares			
Stock Surplus (Share Premium)			
Eligible Minority Interest of third parties in Consolidated Subsidiaries			
Retained earnings			
Revaluation reserve			
Fair Value reserve			
Statutory Reserve			
Voluntary Reserve			
Other Disclosed Reserves			
Treasury share reserve			
Other 1			
Other 2			
Other 3			
Other 4			
Other 5			
<b>Total Qualifying Capital</b>			

Regulatory Adjustments	CET 1	AT 1	T2
	A	B	C
Treasury shares			
Dividends (Proposed but not incurred)			
Goodwill			
Other Intangibles			
Reciprocal cross holdings in capital of FIs			
Deductions from Capital Base arising from Investments in FIs			
Other Adjustments 1			
Other Adjustments 2			
Other Adjustments 3			
Other Adjustments 4			
Other Adjustments 5			
Total Deductions			
Total Eligible Regulatory Capital (post deductions)			

**MARKET RISK**

KD '000s

**Table 2**

**Market Risk Capital Requirements**  
**For the financial period ending    /    /**

Market Risk Capital Requirements / Summary				
No	Market Risk Capital Requirement	Specific	General	Total Capital Requirement
		A	B	C
1	Interest rate risk			
2	Equities risk			
3	Foreign exchange risk			
4	Commodities risk			
5	Options risk			
Total				
Multiplier				1.875
Market Risk Capital Requirement				



**MARKET RISK**

KD '000s

**Table 2-A****Market Risk Capital Requirements**

For the financial period ending / /

**Interest rate risk****Specific risk**

Category of Debt Instruments	Credit Quality Grades	Remaining Maturity	Risk Charge	Current Market Value	Capital Charge
			A	B	A X B = C
Government Debt Instruments	1	N/A			
	2 and 3	6 months or less	0.25%		
		Over 6 and less than 24 months	1.00%		
		Over 24 months	1.60%		
4,5 and 6	N/A	12.00%			
Fully Guaranteed Debt Instruments issued by PSEs (Qualifying)		6 months or less	0.25%		
		Over 6 and less than 24 months	1.00%		
		Over 24 months	1.60%		
Other Debt Instruments		N/A	12.00%		
Total Specific Risk Charge					

**Notes**

## 1. Current market value (B):

The total market value must be filled (sum of absolute value of long and short positions) of debt instruments broken down by obligor, i.e., government, qualifying (broken down further by residual term to maturity), and others. All currencies are combined on a single schedule to arrive at the total for each category, (i.e., total of government, qualifying and others), whereby all values, whether representing long or short positions, must be positive amounts.

## 2. Capital Charge (C):

Multiply the current market value in each obligor category (Column B) by the associated risk charge (Column A).

## MARKET RISK

KD '000s

Table 2-B

**Market Risk Capital Requirements**  
**For the financial period ending    /    /**  
**Interest rate risk**  
**General risk**

**Please repeat table for each currency** Use separate schedule for each currency where position is KD 30,000 or more, and one total schedule for other insignificant currencies where position is less than KD 30,000

Time band	Long Position	Short Position	Gross Position*	Risk Charge	Capital Requirement
	A	B	C=A+ B	D	C X D
Up to 1 month					
Over 1 to 3 months				0.20%	
Over 3 to 6 months				0.40%	
Over 6 months to one year				0.70%	
Over 1 to 1.9 years				1.25%	
Over 1.9 to 2.8 years				1.75%	
Over 2.8 to 3.6 years				2.25%	
Over 3.6 to 4.3 years				2.75%	
Over 4.3 to 5.7 years				3.25%	
Over 5.7 to 7.3 years				3.75%	
Over 7.3 to 9.3 years				4.50%	
Over 9.3 to 10.6 years				5.25%	

<u>Over 10.6 to 12 years</u>				<u>6.00%</u>	
<u>Over 12 to 20 years</u>				<u>8.00%</u>	
<u>Over 20 years</u>				<u>12.50%</u>	
<u>Total</u>					

\* Gross Position is based on Long Position (A) and the absolute value of the short Position (B)

### Table Notes

1. Allocate the market value of all debt instruments, together with other instruments that are subject to interest rate exposure (such as derivatives), into the time bands shown on the return. Show long and short positions separately (column A and B).
2. Sum the absolute value of long position and the absolute value of short position to produce a gross positions figure (column C).
3. Multiply the gross positions amounts by the respective risk charge (column D) to arrive at the risk charge figures which should be summed to give the capital requirement for general market risk.

## MARKET RISK

KD '000s

## Table 2-C

## Market Risk Capital Requirements

For the financial period ending / /

## Equity risk

Country	Long Positions Securities	Short Positions Securities	Long Position Derivatives	Short Position Derivatives	Gross Position	Net Position	Specific Charge	General Charge	Total Capital Charge
	A	B	C	D	E= A+(B)+C +(D)	F=A+B+ C+D	G=E*8%	H=F*8%	I=G+H
Kuwait									
USA									
UK									
Germany									
Switzerland									
Japan									
Other									
Total									

\*Gross Position is based on long position (A+C) and the absolute value of the short position (B+D)

## Notes

1. Equity positions, in securities as well as those arising either directly or indirectly through derivatives, should be allocated to the country in which each equity is listed.

2. The calculations outlined above should be applied to each country. Blank rows are left for licensed persons to mention countries not outlined in the return. For the purposes of disclosure, the terms “country “ and “ national market “ are used synonymously.

3. In case an equity is listed in more than one country, one country should be chosen. Matched positions in each identical equity or stock index in each country may be fully offset, resulting in a single net short or net long position to which the specific and general market risk charges will apply.

4. Long Positions (A) & (C):

For each national market (country), the long positions should be reported for both securities and derivatives.

5. Short Positions (B) & (D):

For each national market (country), the short positions should be reported for both securities and derivatives.

6. Gross Positions (E):

The gross position represents the absolute sum of the value of all long positions and the absolute value of all short position i.e.,  $A+(B)+C+(D)$ .

7. Net position (F):

Sum the long positions and the short positions and report the absolute value i.e.,  $A+B+C+D$

8. Specific Capital Charge (G):

Multiply the gross positions in Column E by 8%.

9. General Capital Charge (H):

Multiply the net position in Column F by 8%.

10. Total Capital Charge (I):

Record the sum of capital charges reported in G and H.

**MARKET RISK**

KD '000s

**Table 2-D**

**Market Risk Capital Requirements**  
**For the financial period ending    /    /**  
**Foreign exchange risk**

Currency	Net Spot Position	Net Forward Position	Guarantee and similar instruments	Net Unearned Income / Expenses	Net Open Position E=A+B+C+D
	A	B	C	D	E
US dollar					-
UK pound					-
Euro					-
Swiss franc					-
Japanese yen					-
Others - Long					-
Others - Short					-
Gold					-

Sum of net open long position	F	
Sum of net open short position (expressed in absolute value)	G	
Greater of box F and box G	H	
Absolute value of open position in gold	I	
Sum of box H and box I	J	
Capital charge (8% of box J)	K	

## Notes

1. All on and off-balance sheet items denominated in a foreign currency are subject to this charge.
2. Licensed persons should report separately their exposure in each foreign currency where the exposure is greater than KD 30,000. The calculation of positions in all other currencies should be performed separately and then aggregated. Structural positions should be excluded.
3. Net Spot Position (A):  
For each currency, report the difference between all assets' items and liabilities items. Include the accrued interest and accrued expenses.
4. Net Forward Position (B):  
For each currency, report all net amounts under forward foreign exchange transactions, including currency futures and the principal on currency swaps not included in the net spot position. Value the position at spot market exchange rates using mid-market rates.
5. Guarantees (C):  
For each currency, report guarantees and other similar instruments. Guarantees must be certain to be called and likely to be irrecoverable.
6. Net unearned Incomes and Expenses (D):  
For each currency, report any net unearned incomes or expenses.
7. Net Open Position (E):  
For each currency, report the sum of net open positions in Column E.
8. Gold:  
Record the net long or net short position in gold.
9. Required Capital Calculation:
  - In box (F): record sum of the absolute value of the total net long positions reported in Column (E).
  - In box (G): record sum of the absolute value of the total net short positions reported in Column (E).
  - In box (H): record the greater of the absolute values of the total net long positions (F) or the total net short positions (G).
  - In box (I): record the absolute value of the open positions in gold.
  - In box (J): record the sum of box (H) and box (I).
  - To arrive at the capital requirement for foreign exchange risk, multiply the sum recorded in box (J) by 8%

## MARKET RISK

KD '000s

Table 2-E

**Market Risk Capital Requirements**  
**For the financial period ending    /    /**  
**Commodities risk**

Commodity	Long Position	Short Position	Gross Position*	Net Position	Capital Charge on Net Position	Capital Charge on Gross Position	Total Capital Charge
	A	B	$C=A+[B]$	$D=A+B$	$E=D*15\%$	$F=C*3\%$	$G=E+F$
Platinum							
Palladium							
Silver							
Copper							
Natural Gas							
Wheat							
Corn							
Canola							
Other 1							
Other 2							
Other 3							
Other 4							
Total							

\* Gross Position is based on Long Position (A) and the absolute value of the Short Position (B)



## Notes

1. All on and off-balance sheet commodity positions are subject to this charge. Commodities include any physical product that can be traded on a secondary market, (e.g., agricultural products, minerals (including oil), and precious metals excluding gold).
2. Licensed persons should report their exposure in platinum, palladium, silver, Oil, natural gas, wheat, corn, canola and each of the other commodities separately. Rows should be added by licensed persons to mention commodities not outlined in the return.
3. Positions in commodities should be based on the respective standard unit of measurement (e.g., barrels, kilograms, grams) and converted into Kuwaiti dinars at spot rates using mid-market prices. Commodity derivatives and other off-balance sheet positions that are affected by changes in commodity prices (excluding options) are to be converted into notional positions using the current spot prices.
4. Long Positions (A):  
For each commodity, record the sum of all long positions, in equivalent Kuwaiti Dinars.
5. Short Positions (B):  
For each commodity, record the sum of all short positions, in equivalent Kuwaiti Dinars.
6. Gross Position (C):  
For each commodity, record the sum of the absolute values of the long and short positions.
7. Net Position (D):  
For each commodity, record the sum of the long position value and short positions.
8. Capital Charge on Net Position (E):  
Multiply the net positions [ in column (D) ] by 15%.
9. Capital Charge on Gross Position (F):  
Multiply the gross positions [ in column (C) ] by 3%.
10. Total Capital Charge on Commodity Risk (G):  
Record the sum of the net position requirements [ column (E) ] and the gross position requirements [ column (F) ].

**MARKET RISK**

KD '000s

**Table 2-F**

**Market Risk Capital Requirements**  
**For the financial period ending / /**  
**Options risk**

**Simplified Method**

Position	Risk Exposure	Market Value of the options Underlying	Sum of Specific and General Market risk charges of the Underlying (%)	Market Value of Options	Amount the Option is in the Money	Capital Charge: Long Underlying/ Long Put or Short Underlying /Long Call	Capital Charge: Long Call or Long Put	Total Capital Charge
		A	B	C	D	$E = (A \times B) - D$	F	$G = E + F$
Long underlying/ Long put or Short underlying/ Long call	Interest Rate position Risk							
	Equity Risk							
	Foreign Exchange Risk							
	Commodities Risk							
	Total							

Long Call or Long Put	Interest Rate							
	Position Risk							
	Equity Risk							
	Foreign Exchange Risk							
	Commodities Risk							
	Total							
Total Options								

## Notes

1. This Form is to be populated in line with the 'Simplified method' for Options as per the applicable section in the guidelines.

2. Market value of the options underlying (A):

Report aggregate information on the market value of the options' underlying by position and risk exposure.

3. Sum of specific and general market risks percentages (B):

Report the sum of the appropriate specific risk and general market risk charge by referring to sections on interest rate positions risk, equity risk, foreign exchange risk and commodity risk.

4. Market value of option (C):

Calculate and report the market value of the option.

5. Amount option is in the money (D):

Report the amount by which the option is in the money. In the money means that the exercise level of a "call option" is less than the mark to market value of the underlying instrument, and for "put option" that the mark to market of the underlying is less than the exercise level of the put option.

6. Capital Charge (E) and (F):

Calculate the capital charge in accordance with the method described in the directives.

7. Total Capital Charge (G):

The total capital charge is sum of column (E) and column (F).

## OPERATIONAL RISK

KD '000s

Table 3

**Operational Risk Capital Requirements**  
**For the financial period / /**

Business Line	Yr (-2)	Yr (-1)	Yr (0)
	Capital Charge = Gross Income* Beta	Capital Charge = Gross Income* Beta	Capital Charge = Gross Income* Beta
	A	B	C
Brokerage			
Trading/Investment			
Investment Portfolio / CIS Management & Managing any Client Asset			
Providing Financing			
Payment and settlement, Clearing and Market Making			
Custodian			
All Other			
Max [sum of yearly charges,0]			
3 year average of sum of yearly charges			
Multiplier			1.875
Total Operational Risk Capital Requirement (3 year average of sum of yearly charges * 1.875)			
Notes			
1. In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines. However, where the aggregate capital charge across all business lines within a given year is negative, then the input to the numerator for that year will be zero.			
2. Gross income shall be calculated as sum of the following for each business line separately:			
Gross income components	Amount		
Interest income	XXXX		
Dividend income	XXXX		
Fees and commission income	XXXX		
Income from other activities	XXXX		
Total gross income	XXXX		
Gross of operating expenses (including fees paid for outsourcing services) and before any provisions. It excludes profit/loss arising from extraordinary or irregular items and income derived from insurance exposures.			

## INVESTMENT RISK

KD '000s

Table 4

## Capital Requirements for Investment Risk

For the financial period ending / /

Page (1) of (1)

No	Investments in Real Estate (30%)	Total Exposure	Capital Requirement
		A	B
1	Total Investments in Real Estate		

No	Equity investment in Financial Institutions (below threshold for deduction and subject to 37.5% charge)	Total Exposure	Capital Requirement
		C	D
1	Investments in FIs below deduction threshold		

No	Investments in High-risk exposures (60%)	Total Exposure	Capital Requirement
		E	F
1	Investment in Unlisted Equities classified as investments in associates/joint venture		
2	Investment in venture capital or private equity		
3	Wakālah instruments not assigned to any of the standard portfolios (article 9-6)		
4	Musharaka exposure - Investments in private and commercial projects (60% capital charge)		
5	Diminishing Musharaka exposure - Working capital finance (60% capital charge)		
6	Other Unspecified investments		

No	Investments in Funds (article 4-61 b) – (30%)	Total Exposure	Capital Requirement
		G	H
1	Investments in Funds		

#	Other Investments in Equities (15%)	Total Exposure	Capital Requirement
		I	J
1	Investment in equities classified as financial assets at fair value through the other comprehensive income		
2	Investments in listed equities classified as investments in associates/joint venture		

Total Investment Risks Capital Requirement (B+D+F+H+J)	
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## CREDIT RISK

KD '000s

Table 5

**Credit Risk Capital Requirements**  
For the financial period ending / /

No	Asset Categories	On & Off-Balance Sheet Exposures				
		On Balance Sheet Exposure	Off Balance Sheet Exposure - Credit Equivalent Amount	Eligible CRM	Net Exposure	Credit Risk Capital Requirement
		A	B	C	D	E
1	Cash Items					
	Notes and Coins					
	Gold bullion held in the vaults					
	Cheques and Drafts Drawn on other Banks and Immediately Payable or in the Process of Collection					
	Receiveable Funds arising from the sale of securities					
	Receivable Funds arising from the purchase of securities					
2	Exposures to Sovereign					
	CQG 1 (AAA to AA-)					
	CQG 2 (A+ to A-)					
	CQG 3 (BBB+ to BBB-)					
	CQG 4 (BB+ to BB-)					
	CQG 5 (B+ to B-)					
	CQG 6 (Below B-)					
	Unrated					
3	Exposures to PSEs					
	Kuwaiti PSEs - Local Currency					
	Kuwaiti PSEs - Foreign Currency					
	Other GCC PSEs					
	Other GCC PSEs - Local Currency					
	Other GCC PSEs - Foreign Currency					



	Foreign PSEs					
	CQG 1 (AAA to AA-)					
	CQG 2 (A+ to A-)					
	CQG 3 (BBB+ to BBB-)					
	CQG 4 (BB+ to BB-)					
	CQG 5 (B+ to B-)					
	CQG 6 (Below B-)					
	Unrated					
4	Exposures to Banks					
	CQG 1 (AAA to AA-)					
	CQG 2 (A+ to A-)					
	CQG 3 (BBB+ to BBB-)					
	CQG 4 (BB+ to BB-)					
	CQG 5 (B+ to B-)					
	CQG 6 (Below B-)					
	Unrated					
5	Exposures to Corporates					
	CQG 1 (AAA to AA-)					
	CQG 2 (A+ to A-)					
	CQG 3 (BBB+ to BBB-)					
	CQG 4 (BB+ to BB-)					
	CQG 5 (B+ to B-)					
	CQG 6 (Below B-)					
	Unrated					
6	Exposures to Central Counterparties					
	Exposures to Qualifying CCP					
	Exposures to Non-Qualifying CCP (including default fund exposures)					
7	Credit facilities to finance trading in real estate and trading in securities					
8	Other exposure					
9	Grand Total					

**COUNTERPARTY CREDIT RISK**

KD '000s

**Table 6****Counterparty Credit Risk Capital Requirements**

For the financial period ending / /

No	Counterparty credit risk	Capital Requirement
1	CCR Capital Charge	
2	CVA Capital Charge	
CCR and CVA Capital Requirement		

**AUM RISK CAPITAL REQUIREMENTS**

KD '000s

**Table 7**

**Capital Requirements for AUM**  
**For the financial period ending / /**

No	Assets under Management (AUM)	Rolling Average AUM over last 12 months	Capital Requirement
		A	B
1	Rolling Average AUM over last 12 months		

AUM Risk Capital Requirement (B)	
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## OTHER EXPOSURES CAPITAL REQUIREMENT

KD '000s

Table 8

## Capital Requirements for Other Exposures

For the financial period ending / /

No	Other Exposures	Total	Capital Requirement
		A	B
1	Exposures to fixed assets, plant, equipment and machinery (capital charge 15%)		
2	Exposures resulting from Istisnã contracts (Cases where a parallel Istisnã contract is not executed) (capital charge 18%)		
3	Exposures to WIP inventory (capital charge 30%)		
4	Exposures not specified elsewhere (capital charge 15%)		
	Total		

Other Exposure Risk Capital Requirement (B)	
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**FINANCIAL MARKET INFRASTRUCTURE**

KD '000s

**Table 9**

**FMI "Continuity" Capital Requirements**

**For the financial period ending / /**

No	Operational Expenses over time period required for "winding down"/"recovery" (Minimum 6 months)	Total	Capital requirement
		A	B
1	Total		

FMI capital requirement (B)	
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**Notes**

In line with articles 5-1 to 5-5 this is relevant only to FMIs and stock exchange, and the reporting figure should include the running/operational cost of the entity for a period of 6 months as observed historically.