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البنك المركزي الصومالي

CENTRAL BANK OF SOMALIA

Licensing and Supervision Department

REGULATION ON CAPITAL ADEQUACY

CBS/BS/REG/02

(As Amended 2023)

Contents

1. INTRODUCTION

1.1. Authority

This regulation is made by the Central Bank pursuant to its authority set forth in Sections14(1)-(2), 15(1), and 34of the Financial Institution Law, 2012 ("FIL"), and Sections 38(1) and 52(1) of the Central Bank of Somalia Act, 2012, for the purpose of implementing Sections 14 (Minimum Capital Requirements), 15 (Minimum Ongoing Capital Requirements), and 18 (Submission of Forms for Capital Adequacy Computation) of the FIL. This regulation shall replace the current CBS regulation on Capital Adequacy 2014.

1.2. Applicability

This regulation applies to all financial institutions licensed by the Central Bank to engage in banking business.

1.3. Scope

(1) All the remaining articles of this regulation must be applied by each financial institution on a stand-alone basis, i.e., on a basis that does not consolidate assets and liabilities of any subsidiaries.

(2) The CBS can exempt specific financial institutions (e.g Foreign Branches) from this regulation, on a case by case basis.

2. REGULATORY CAPITAL

Regulatory capital consists of two categories, each governed by a single set of criteria:

- Tier 1 Core Capital, and
- Tier 1 Complementary Capital.

2.1. TIER 1 CORE CAPITAL

2.1.1. Definition

Tier 1 Core Capital (CC), on a given calculation date, consists of the total amount of CC Group 1 deducted of the total amount of CC Group 2.

Tier 1 Core Capital = CC Group 1 – CC Group 2

2.1.2. CC Group 1

(1) CC Group 1 comprises the sum of the amounts of the four elements below:

a) Unimpaired ordinary paid-up shares of common equity, or assigned capital in the case of a foreign financial institution,

b) Shares premium resulting from the issuance of instruments included in CC Group 1,

c) Accumulated retained earnings in the amount reported in the last audited financial statement available; and

d) Accumulated disclosed reserves in the amount reported in the last audited financial statement available except for the following:

i. Profit Equalization Reserve (PER),

ii. Investment Risk Reserve (IRR),

iii. Revaluation reserves.

(2) Dividends must be removed from the calculation of CC Group 1, in accordance with applicable accounting rules.

(3) The amounts of CC Group 1 elements in (1) (a) and (b) must be based on the values registered, at the calculation date, on the related audited accounts included in the financial statements.

2.1.3. CC Group 2

(1) CC Group 2 comprises the sum of the amounts of the six elements below:

a. Goodwill and all other intangibles,

b. Deferred taxes assets that rely on future profitability of the financial institution to be realised,

c. Financial institution´s investment, whether held directly or indirectly, in fully paid-up shares of its own common equity,

d. Financial institution´s investment, whether held directly or indirectly, in fully paid-up shares of common equity of other financial institutions, or insurance companies,

e. Financial institution´s investment, whether held directly or indirectly, in fully paid-up shares of equity in subsidiaries, and

f. Financial exposures to related persons of the financial institution which are not authorized by or which exceed the limitations of Section 103 of the FIL or the Central Bank's Regulation on Transactions with Related Persons.

(2) Exposures to its own common equities which the financial institution could be contractually obliged to purchase should also be included in CC Group 2.

(3) Exposures to common equities of other financial institutions, insurance companies which the financial institution could be contractually obliged to purchase must also be included in CC Group 2.

(4) Exposures to equities of subsidiaries which the financial institution could be contractually obliged to purchase must also be included in CC Group 2.

(5) The amounts of CC Group 2 elements must be based on the values registered, at the calculation date, on the related audited accounts included in the financial statements.

2.2. TIER 1 COMPLEMENTARY CAPITAL

(1) Tier 1 Complementary Capital comprises the sum of the current year-to-date interim items:

a. Profit or loss, net of taxes; and

b. Other comprehensive income, net of taxes.

(2) The amounts of Tier 1 Complementary Capital elements must be based on the values registered on the related accounts included in the most recent financial statement available.

2.3 . TOTAL REGULATORY CAPITAL

Total regulatory capital is the sum of Tier 1 Core Capital and Tier 1 Complementary Capital.

3. REGULATORY REQUIREMENTS

(1) The quantitative and qualitative regulatory requirements described below must be met at all times.

(2) Financial institutions must immediately report to CBS situations in which the quantitative requirements have fallen, or are expected to fall, below the minimum thresholds.

3.1. QUANTITATIVE REGULATORY REQUIREMENTS

3.1.1. CORE CAPITAL ADEQUACY RATIO

(1) At any given date, the minimum Core Capital Adequacy Ratio of 8% (eight percent) must be met:

(Tier 1 Core Capital / Risk Weighted Assets) ≥ 8%

(2) The Risk Weighted Assets must be determined as prescribed in:

a. Appendix 1, and

b. Appendix 4, for Islamic transactions.

3.1.2. TOTAL REGULATORY CAPITAL ADEQUACY RATIO

(1) At any given date, the minimum Total Regulatory Capital Adequacy Ratio of 12% (twelve percent) must be met:

(Total Regulatory Capital / Risk Weighted Assets) ≥ 12%

(2) The Risk Weighted Assets must be determined as prescribed in:

a. Appendix 1, and

b. Appendix 4, for Islamic transactions.

3.2. QUALITATIVE REGULATORY REQUIREMENTS

3.2.1. INSTITUTIONAL GUIDELINES

3.2.1.1. RISK APPETITE STATEMENT (RAS)

(1) The Board of directors of each financial institution is responsible for approving a documented Risk Appetite Statement (RAS) that expresses, at the highest institutional level, its directions on the types of risk and the respective maximum amounts accepted for each one that the institution is willing to take in order to meet its strategic objectives.

(2) The RAS must:

a. be reviewed annually,

b. be consistent with the strategic planning,

c. list, in a very clear way, the types and maximum levels of risks that the institution is willing to incur, broken down by type of risk and, when applicable, by different time horizons,

d. be commensurate with the institution's ability to manage its risks in an effective and prudent manner,

e. consider the competitive conditions and the regulatory landscape, and

f. Include proper procedures for its revision under stressful situations.

3.2.1.2. REGULATORY CAPITAL PLAN

(1) The Board of directors of each financial institution, together with senior management, is responsible for approving a documented institutional regulatory capital plan that should:

a. be reviewed annually,

b. be consistent with the strategic planning, and

c. Provide, for a three-year horizon, targets and projection for regulatory capital, discriminating its main sources.

(2) The following aspects must be considered under the regulatory capital plan:

a. threats and opportunities related to the economic and business environment,

b. projections of values of assets, liabilities and off-balance sheet exposures, as well as of incomes and expenses,

c. targets for growth or market participation,

d. the dividend policy; and

e. The RAS.

3.2.1.3. REGULATORY CAPITAL CONTINGENCY PLAN

The Board of directors of each financial institution, together with senior management, is responsible for approving a documented institutional regulatory capital contingency plan that must:

a. be reviewed annually,

b. be consistent with the Regulatory Capital Plan,

c. establish protocols that senior management must follow to preserve capital during economic downturns and other events which threatens the regulatory capital, and

d. specify clear thresholds that will trigger the established protocols.

3.2.2 RISK MANAGEMENT COMMITTEE

The board of directors must establish a Risk Management Committee consisting of at least three of its members for the purpose of providing oversight of the efforts to manage the risks to which the financial institution is exposed.

3.2.3. RISK MANAGEMENT STRUCTURE

(1) Financial institutions must implement a structure for continuous and integrated risk management that is:

a. commensurate with the business model, nature of operations and complexity of its products, services, activities, and processes,

b. proportional to the magnitude and materiality of risk exposures, according to criteria defined internally,

c. adequate to its risk profile and systemic importance, and

d. cognizant of risks arising from the macroeconomic environment and the markets in which it operates.

(2) The risk management structure must allow for the identification, measurement, evaluation, monitoring, reporting, control, and mitigation of, at least:

a. credit risk,

b. operational risk,

c. foreign exchange risk,

d. liquidity risk, and

e. Other risks, when material deemed by the institution.

(3) Credit risk is defined as the risk of losses resulting from the default or failure of a borrower, counterparty or guarantor to meet its obligations in accordance with agreed terms.

(4) Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk and Shariah compliance risk but excludes strategic and reputational risk.

(5) Foreign exchange risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in foreign exchange rates.

(6) Liquidity risk is defined as the risk of not being able to meet efficiently both expected and unexpected current and future cash flows and collateral needs without affecting either daily operations or the financial conditions of the firm.

(7) The risk management structure must follow the prescriptions of Annex 2.

3.2.4. CAPITAL MANAGEMENT STRUCTURE

(1) Financial institutions must implement a structure for continuous and integrated capital management that is responsible for:

a. monitoring and controlling the level of regulatory capital held,

b. assessing the regulatory capital deemed necessary to face the risks incurred, and

c. planning regulatory capital targets and needs, considering the strategic goals.

(2) The capital management must be performed by a specific unit, properly segregated from business units and from the unit that conducts the internal audit, and with proper independence to perform its duties.

(3) The capital management unit must be sufficiently staffed by members with expertise and qualification in managing capital.

(4) The capital management framework must comprise:

a. documented policies and strategies for capital management, establishing procedures aimed at maintaining a Tier 1 Core Capital compatible with the risks faced by the institution and with the quantitative requirements of this regulation,

b. systems and procedures for monitoring, controlling and reporting capital management,

c. an institutional regulatory capital plan,

d. an institutional regulatory capital contingency plan,

e. timely reports to the Board, the risk committee, and the senior management on:

i) deficiencies in the capital management framework and actions to address them; and

ii) Adequacy of the levels of regulatory capital considering the risk-taking activities.

(5) All capital management structure policies must be approved and subject to a properly documented annual review by the Board.

(6) Both the regulatory capital plan and the regulatory capital contingency plan must be formally approved and reviewed annually by the Board.

4. RESTRICTIONS ON CAPITAL DISTRIBUTIONS

(1) No financial institution must make a voluntary capital distribution unless it exceeds, and will continue to exceed after making the distribution, the minimum thresholds required for quantitative regulatory requirements, as defined in section 3.1.

(2) A financial institution with regulatory capital ratios below the thresholds defined in section 3.1, will not be allowed to make any capital distributions and will only be able to reinstate those distributions after a formal clearance by the Central Bank.

(3) A financial institution with regulatory capital ratios above the threshold defined in section 3.1.2 will be allowed to make capital distributions in accordance with the following guidelines:

Core Capital Ratio	Maximum annual earnings payout Ratio Permitted
8.0 – 10.0%	25%
10.1 – 12.0%	50%
12.1 – 14.0 %	75%
14.1% +	100%

5. REPORTING (1) No later than the close of business of the 15th day after the last day of any month and in the format prescribed by the CBS, each financial institution must submit to the CBS a report showing the calculation of its quantitative regulatory requirements in accordance with this regulation. (2) A financial institution must be able to demonstrate to the Central Bank, at all times, its compliance with the qualitative requirements prescribed in this regulation.
6. SANCTIONS (1) If any of the assumptions behind the calculation of a quantitative requirement by a financial institution is considered inadequate, the CBS may determine proper and prompt adjustments. (2) If the qualitative requirements implemented by a financial institution are deemed by the CBS inadequate or not consistent with its risk profile, corrective measures may be requested by the CBS.
7. EFFECTIVE DATE The requirements included in that regulation will apply to financial institutions beginning on 1 January 2024.

CENTRAL BANK OF SOMALIA

Regulation on Capital Adequacy

(Revised November 2022)

Appendix 1

Risk Weighted Assets

1. RWA DEFINITION

A financial institution´s Risk Weighted Assets (RWA), on a given calculation date, consists of the sum of two components: RWA_{CRED} and RWA_{OPER}.

$RWA = RWA_{CRED} + RWA_{OPER}$

Where:

- RWA_{CRED} is the amount of risk weighted assets related to credit risk, as defined in item nº 2, and
- RWA_{OPER} is the amount of risk weighted assets related to operational risk, as defined in item nº 3.

2. RWA_{CRED}

2.1. Definition

The RWA_{CRED} component is determined based on the standardised approach for calculating the risk-based capital requirement for credit risk.

2.2. Periodicity

The RWA_{CRED} must be calculated monthly, based on the existent exposures at the last day of the calculation month.

2.3. Calculation

The RWA_{CRED} component equals the total sum of the risk weighted credit exposures (RWexp).

$$RWA_{CRED} = \sum_i RWexp_i$$

Where:

$$RWexp_i = EXP_i * RW_i$$

- EXP is related to an individual exposure as defined in 2.3.1, and
- RW is related to the risk weight assigned to an EXP, as prescribed in 2.3.2 and Appendix 4.

2.3.1. EXPOSURE

For purposes of RWA_{CRED} computations, exposures are determined as described in this section, discriminating between on-balance and off-balance sheet items.

2.3.1.1. On-balance sheet items

(1) The following items registered as assets in the balance sheet should be considered when determining exposures:

a. Any acquisition of assets and rights,

b. Expenditures or expenses registered as assets, and

c. Any advance granted.

(2) The calculation of the exposure value for those items must be net of specific provisions (including partial write-offs) and consider the deduction of any advances received, and any income to be appropriated.

2.3.1.2. Off-balance sheet items

(1) The following items not registered in the balance sheet must be considered when determining exposures:

   a) commitments that are not cancellable unconditionally and unilaterally by the institution,

   b) commitments that are cancellable unconditionally and unilaterally by the institution,

   c) committed funds to be released in up to 360 days, and

   d) Guarantees, collaterals, co-obligations or any other type of personal pledge of fulfilment of a third party's financial obligation.

(2) The above off-balance sheet items will be converted into credit exposure equivalents using the following credit conversion factors (CCF):

   a) A 10% CCF applies to commitments that are unconditionally cancellable at any time by the financial institution without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower´s creditworthiness,

   b) A 40% CCF applies to commitments not eligible to a 10% CCF,

   c) A 20% CCF applies to self-liquidating trade letters of credit arising from movement of goods with a maturity below one year,

   d) A 100% CCF applies to direct credit substitutes, such as:

      i. general guarantees of indebtedness,

      ii. acceptances,

      iii. sale and repurchase agreements, and

      iv. forward asset purchase agreements, and

   e) A 50% CCF applies to off-balance sheet items not listed above.

(3) Commitments, regardless of their maturity, must be always included.

(4) In the case of commitments, the committed but undrawn amount of the exposure must be multiplied by the CCF.

(5) The calculation of the credit exposure equivalents for off-balance sheet items must consider the deduction of any advances received, provisions made and any income to be appropriated.

2.3.2. RW

This section defines the appropriate risk weights related to predefined sets of exposure types, discriminating between on-balance and off-balance sheet exposures.

2.3.2.1. 0% risk weight

A 0% risk weight applies to exposures:

a) On cash owned and held at the financial institution or in transit.
b) To the Federal Government of Somalia and the Central Bank of Somalia (CBS).
c) to the following multilateral development banks: the World Bank Group comprising the International Bank for Reconstruction and Development, the International Finance Corporation, the Multilateral Investment Guarantee Agency and the International Development Association, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, the International Finance Facility for Immunization, and the Asian Infrastructure Investment Bank
d) with the explicit guarantee of the Federal Government of Somalia or the CBS; and
e) on sovereigns or central banks with an external credit rating currently above or equal to AA- or Aa3.

2.3.2.2. 20% risk weight

A 20% risk weight applies to exposures on:

a) cash items in the process of collection,
b) sovereigns or central banks with an external credit rating currently:
    1. above BBB+ or Baa1, and
    2. Below AA- or Aa3.

2.3.2.3. 50% risk weight

A 50% risk weight applies to exposures on sovereigns or central banks with an external credit rating currently:

a) above BB+ or Ba1, and
b) Below A- or A3.

2.3.2.4. 75% risk weight

A 75% risk weight applies to exposures to an individual person or persons.

2.3.2.5. 100% risk weight

A 100% risk weight applies to exposures on:

a) sovereigns or central banks:
    1. without an external credit rating, or
    2. with an external credit rating currently:
        a) above CCC or Caa, and
        b) Below BBB- or Baa3.
b) corporates and enterprises, and
c) All other assets without a specific risk weight prescribed.

2.3.2.6. 150% risk weight

A 150% risk weight applies to exposures on:

a) sovereigns or central banks with an external credit rating currently below B- or B3,
b) financial institutions,
c) financing land acquisition for development and construction purposes, and
d) Financing the development and construction of any residential or commercial property.

2.3.2.7. 187.5% risk weight

A 187.5% risk weight applies to exposures on real estate investments, which comprises:

a) the activity of holding real estate at any stage of the development process, or even completed properties, where such a holding is not part of a financing transaction for a third party, or
b) an asset holding where there is no binding promise from a third party to acquire or to lease the asset, and the holding period has exceeded a relatively short period such as six months (at supervisory discretion) and based on evidence of management intention.

2.3.2.8. 250% risk weight

A 250% risk weight applies to exposures on equity holdings, except those defined in 2.3.2.9.

2.3.2.9. 400% risk weight

A 400% risk weight applies to exposures on equity investments in unlisted companies that are invested for short-term resale purposes or are considered venture capital or similar investments which are subject to price volatility and are acquired in anticipation of significant future capital gains.

2.3.3. Defaulted Exposures

(1) The following risk weights applies to a defaulted exposure, which must be net of specific provisions and partial write-offs:

a. 150% when specific provisions are less than 20% of the outstanding amount of the related operation,

b. 100% when specific provisions are equal or greater than 20% of the outstanding amount of the related operation.

(2) A defaulted exposure, for the calculation of the RWACRED, is defined as one that is past due for more than 90 days or is an exposure to a defaulted borrower.

(3) A defaulted borrower, for the calculation of the RWACRED, is a borrower in respect of whom any of the following events have occurred:

a. Any material credit obligation is past due for more than 90 days, with overdrafts considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstanding;

b. Any material credit obligation is on non-accrued status (eg the lending financial institution no longer recognizes accrued profit as income or, if recognized, makes an equivalent amount of provisions);

c. A write-off or account-specific provision is made as a result of a significant perceived decline in credit quality subsequent to the financial institution taking on any credit exposure to the borrower.

d. Any credit obligation is sold at a material credit-related economic loss;

e. A distressed restructuring of any credit obligation (ie a restructuring that may result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, profit or (where relevant) fees) is agreed by the financial institution;

f. The borrower's bankruptcy or a similar order in respect of any of the borrower's credit obligations to the banking group has been filed;

g. The borrower has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of any of the credit obligations to the banking group; or

h. Any other situation where the financial institution considers that the borrower is unlikely to pay its credit obligations in full without recourse by the financial institution to actions such as realizing security.

3. RWA_{OPER}

3.1. Definition

The RWA_{OPER} component is determined based on the standardised approach for calculating the risk-based capital requirement for operational risk.

3.2. Periodicity

(1) The RWAOPER must be calculated each 12 months, every April, based on the audited annual financial statements from the last three financial years.

(2) The RWAOPER for the following eleven months after April will be equivalent to the amount calculated in (1).

(3) CBS may determine proper and prompt adjustments if a financial institution cannot provide annual financial statements for the last three financial exercises.

3.3. Calculation

The RWA_{OPER} component equals 12.5 times the Business Indicator Component (BIC), which is calculated by multiplying the Business Indicator (BI) by a marginal coefficient of twelve percent.

RWA_{OPER} = 12,5 * BIC

Where:

BIC = BI * 12%

3.3.1. Business Indicator (BI)

The BI, a financial-statement-based proxy for operational risk, is defined as:

BI = ILDC + SC + FC

Where:

a. ILDC stands for profit, leases and dividend component and is defined in 3.2.1.1,
b. SC stands for services component and is defined in 3.2.1.2, and
c. FC stands for financial component and is defined in 3.2.1.3.

3.3.1.1. ILDC

(1) The ILDC is defined by the formulas below:

$ILDC = ILDC_1 + ILDC_2$

Where:

$$ILDC_1 = min\left(\frac{\sum_{t-2}^{t} Abs\ (Interest\ income/Profit - Interest/profit\ expense)}{3}; 2{,}25\% * \frac{\sum_{t-2}^{t} Abs\ (Interest\ earning\ assets)}{3}\right)$$

$$ILDC_2 = \frac{\sum_{t-2}^{t} divided\ income}{3}$$

(2) t corresponds to the audited annual financial statement from the last financial exercise,

(3) t-1 corresponds to the audited annual financial statement from the financial exercise prior to t,

(4) t-2 corresponds to the audited annual financial statement from the financial exercise prior to t-1,

(5) Profit income/profit, as described in Appendix 3 A3.1, and determined for a financial year, according to the financial institution´s financial statement.

(6) Profit expenses, as described in Appendix 3 A3.2, and determined for a financial year, according to the financial institution´s financial statement.

(7) Profit earning assets, as described in Appendix A3.3, measured at the end of a financial year, according to the financial institution´s financial statement.

(8) Dividend income, as described in Appendix A3.4, determined for a financial year, according to the financial institution´s financial statement.

3.3.1.2. SC

(1) The SC is defined by the formulas below:

$SC = SC_1 + SC_2$

Where:

$$SC_1 = max\left(\frac{\sum_{t-2}^{t} Other\ operating\ income}{3};\frac{\sum_{t-2}^{t} Other\ operating\ expense}{3}\right)$$

$$SC_2 = max\left(\frac{\sum_{t-2}^{t} fee\ income}{3};\frac{\sum_{t-2}^{t} fee\ expense}{3}\right)$$

(2) t corresponds to the audited annual financial statement from the last financial exercise,

(3) t-1 corresponds to the audited annual financial statement from the last financial exercise prior to t,

(4) t-2 corresponds to the audited annual financial statement from the last financial exercise prior to t-1,

(5) Other operating income, as described in Appendix 3 A3.5, and determined for a financial year, according to the financial institution´s financial statement.

(6) Other operating expense, as described in Appendix 3 A3.6, and determined for a financial year, according to the financial institution´s financial statement.

(7) Fee and commission income, as described in Appendix 3 A3.7, and determined for a financial year, according to the financial institution's financial statement.

(8) Fee and commission expenses, as described in Appendix 3 A3.8, and determined for a financial year, according to the financial institution´s financial statement.

3.3.1.3. FC

(1) The FC is defined by the formula below:

$$FC = \frac{\sum_{t-2}^{t} Abs\ (Net\ Financial\ P\&L)}{3}$$

(2) t corresponds to the audited annual financial statement from the last financial exercise,

(3) t-1 corresponds to the audited annual financial statement from the last financial exercise prior to t,

(4) t-2 corresponds to the audited annual financial statement from the last financial exercise prior to t-1,

(5) Net Financial P&L, as described in Appendix 3 A3.9, and determined for a financial year, according to the financial institution´s financial statement.

3.4. Financial statement items not to be considered for BI calculation

The following profit and loss items must not be considered for the calculation of the BI:

1) Income and expenses from insurance/Takaful or reinsurance/re-Takaful businesses,
2) Premiums/contribution paid and reimbursements/payments received from insurance/Takaful or reinsurance/re-Takaful policies purchased,
3) Administrative expenses, including staff expenses, outsourcing fees paid for the supply of non-financial services (e.g. logistical, human resources, information technology – IT), and other administrative expenses (e.g. IT, utilities, telephone, travel, office supplies, postage),
4) Recovery of administrative expenses including recovery of payments on behalf of customers,
5) Expenses of premises and fixed assets (except when these expenses result from operational loss events),
6) Depreciation/amortisation of tangible and intangible assets (except depreciation related to operating lease assets, which should be included in financial and operating lease expenses),
7) Provisions or reversal of provisions, except for provisions related to operational loss events,
8) Expenses due to share capital repayable on demand,
9) Impairment or reversal of impairment (e.g. on financial assets, non-financial assets, investments in subsidiaries, joint ventures and associates)
10) Changes in goodwill recognised in profit or loss, and
11) Corporate income tax (tax based on profits including current tax and deferred).

CENTRAL BANK OF SOMALIA

Regulation on Capital Adequacy

(Revised November 2022)

Appendix 2

Risk Management Structure

(1) The risk management function must be performed by a specific unit, properly segregated from business units and from the unit that conducts the internal audit, and with proper independence to perform its duties.
(2) The risk management structure must be sufficiently staffed by members with expertise and qualification in managing risks.
(3) The risk management function must have clearly documented independency, roles and responsibilities in risk management that establish duties to the different levels of the institution's personnel.
(4) The risk management structure must be integrated across risks, allowing for the identification, measurement, evaluation, monitoring, reporting, control, and mitigation of adverse effects arising from interactions among them.
(5) The risk management structure must also consider the interactions among the risks mentioned in article 5.3.2 and the risk of its products and services being used for money laundering or terrorism financing practices, under the terms of the regulation established by the Central Bank of Somalia.
(6) The risk management structure must comprise: a. documented policies and strategies for risk management, establishing limits and procedures designed to maintain the exposures to risk at levels consistent with the ones set in the RAS, b. necessary authorizations, as well as timely and appropriate actions to be taken by senior management and, when necessary, the Board, in case of exceptions to policies, procedures, limits and RAS stipulations, c. effective processes for tracking and timely reporting exceptions to the risk management policies, limits and levels of risk appetite set in the RAS, d. risk management systems, routines and procedures deemed adequate, both under normal circumstances and in periods of stress, e. periodic assessment and evaluation of the adequacy of risk management systems, routines and procedures, f. adequate policies, procedures and controls to ensure a prior identification of risks inherent to: i. new products and services, ii. material modifications to the existing products or services, iii. material changes in processes, systems, operations and the business model, iv. material corporate reorganizations, and v. Changes in the macroeconomic perspectives.

(7)	The risk management structure must provide, on a timely basis and in a suitable form, reports to senior management, and the Board on: a. aggregate risk exposures and their main determinants, b. compliance of risk management with the policies and limits mentioned at item 7a, c. evaluation of the risk management systems, routines and procedures, including the identification of any deficiencies in the structure, as well as actions to address them, and d. Actions taken to mitigate risks, including due to limits breaches, and the assessment of their effectiveness.
(8)	All risk management policies and strategies must be approved by the Board and subject to an annual review.
(9)	The following information must be disseminated to all levels of the institution's personnel in a language and a degree of information commensurate with their assignment: a. risk management policies, strategies, procedures and limits prescribed in the risk management structure, b. procedures for reporting noncompliance with risk limits, and c. Risk-taking behavior, along with its connections with daily risk-taking decisions and activities.

CREDIT RISK

(10) The risk management processes for the management of credit risk must also include:

a. documented policies and procedures for the establishment of credit risk limits, including those for concentration risk,

b. documented policies and procedure to guide the board's decision on incurring an exposure to credit risk that:

   i. exceeds any concentration limit established in risk management policies, either in absolute values or as a percentage of Total Capital,

   ii. Is inconsistent with the risk profile or with the products and services offered.

c. documented policies and procedures, accessible to those involved in the processes of granting and monitoring operations subject to credit risk, describing the criteria for:

   i. prior analysis, granting and renegotiation of operations subject to credit risk,

   ii. the use of relevant and reliable information in the evaluation, review and measurement of credit risk,

   iii. collection and record of the information deemed necessary for a thorough appreciation of the credit risk associated with operations,

   iv. periodic assessment of the sufficiency of mitigation instruments,

   v. identification and prevention of a deterioration in the credit quality of an entity with exposures to the financial institution,

   vi. treatment of exceptions to established limits,

   vii. collection of debts, and

   viii. Forbearance practices (e.g, temporary reduction or postponement of payments on loans/financing).

d. documented policies and procedures for monitoring and reviewing the total indebtedness and the credit quality of counterparties, in which all risk factors are considered, including those associated with unhedged foreign exchange exposures,

e. documented policies and procedures to the management of exposures with similar characteristics, at both individual and aggregate levels, capturing aspects such as the material sources of credit risk, the identification of counterparties or intervenient parties, the form of aggregating exposures and the use of mitigation instruments,

f. documented policies and procedures that establish criteria for the identification of material risk factors, for the purpose of concentration risk management,

g. documented policies and procedures for the management of the credit risk associated with off-balance sheet exposures,

h. documented policies and procedures on the criteria for reviewing the credit quality of counterparties, intervenient parties and mitigation instruments,

i. documented controls ensuring that the levels of provisions are compliant with the accounting regulation in force and sufficient to face the incurred and expected losses, and

j. Systems that identify, classify, aggregate, and control exposures according to the nature of the operation and its credit risk, based on consistent and verifiable criteria, on a timely and consistent basis.

OPERATIONAL RISK

(11) The risk management processes for management of operational risk management are expected to conform to the Operational Risk Guidelines issued by the CBS, and must also include:

a. documented policies and procedures to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis, including those arising from outsourced services that are relevant to the regular operation of the institution,

b. documented policies establishing criteria for decision on the outsourcing of services and selecting their providers, including minimum contractual conditions to mitigate operational risk,

c. adequate Shariah compliance mechanism and fiduciary duty towards investment accounts are in place,

d. adequate training in operational risk is provided to personnel at all levels, including the providers of relevant outsourced services,

e. a consistent and comprehensive documented process to timely:

   i. collect, record, classify and aggregate relevant information on operational losses, and

   ii. Assess the root cause of each material operational loss.

f. use of IT systems, procedures and infrastructure that:

   i. ensure data and systems integrity, security and availability,

   ii. are robust and adequate to the business model and its changes, under normal circumstances and in periods of stress, and

   iii. Include mechanisms for information protection and security, aiming at the prevention, detection and reduction of digital attacks.

FOREIGN EXCHANGE RISK

(12) The risk management processes for the management of foreign exchange risk must also include documented policies, strategies and procedure ensuring:

a. clearly articulated roles and responsibilities for the identification, measurement, evaluation, monitoring, reporting, control and mitigation of foreign exchange risk on a timely basis,

b. appropriate foreign exchange risk limits consistent with the financial institution's risk appetite, risk profile and capital strength, and with the management's ability to manage that risk and which are understood by, and regularly communicated to, relevant staff,

c. exception tracking and reporting processes that ensure prompt action at the appropriate level of the financial institution's senior management or Board, where necessary,

d. Effective information systems for accurate and timely identification, aggregation, monitoring and reporting of foreign exchange risk exposure to the Board and senior management.

LIQUIDITY RISK

(13) The risk management processes for the management of liquidity risk must also include documented policies, strategies and procedures ensuring:

a. the identification, measurement, evaluation, monitoring, reporting, control and mitigation of liquidity risk in different time horizons (including intraday, if materially important), under normal circumstances and in periods of stress, comprising a daily assessment of operations with a maturity less than 90 (ninety) days,

b. an adequate buffer of liquid assets to be promptly converted in cash under stress circumstances,

c. a funding profile that is adequate to the liquidity risk arising from assets and off-balance sheet exposures, and an adequate diversification of the sources of funding, avoiding undue concentrations based on providers and types of instruments, and

d. Systems that identify and control all relevant sources of liquidity risk, based on reliable data from internal and external sources.

(14) The risk management of liquidity risk must also:

a. Consider all operations carried out in the financial and capital markets, as well as contingent or unexpected exposures, such as those arising from settlement services, the provision of endorsements and guarantees, and undrawn credit lines,

b. Consider the liquidity risk individually for each country of operation and for the currency of the exposure, acknowledging possible restrictions to the transfer of funds and to currency conversion, such as those caused by operational problems or by decisions imposed by any given country,

c. Regularly assess the funding sources under normal and alternative, including adverse scenarios,

d. Measure, project, and monitor the net funding requirements over various specified periods of time and under alternative, including adverse scenarios. In analyzing net funding requirements, consideration must be given to how other risks (credit, foreign exchange, and operational risks) may impact the financial institution's overall liquidity strategy, and

e. Analyze its liquidity and its liquidity management plan under various scenarios that differ from the normally expected scenario. The tested scenarios should address both internal (financial institution specific) and external (market related) stress factors across different time horizons and in each currency in which the financial institution is materially active.

CENTRAL BANK OF SOMALIA

Regulation on Capital Adequacy

(Revised November 2022)

Appendix 3

Business Indicator Items

Item	Name	Location	Description
A3.1	Profit income	Income statement	Profit income from all financing and investment assets and other profit income (Includes profit income from financial and operating leases and profits from leased assets)
A3.2	Profit expenses	Income statement	Profit expenses from all financing and investment liabilities and other Profit expenses (includes profit expense from funding, financial and operating leases, depreciation, and impairment of, and losses from, operating leased assets)
A3.3	Profit earning assets	Balance Sheet	Total gross outstanding on financing and investment assets, loans, advances, profit bearing securities (including government bonds/ sukuk), and leased assets measured at the end of each financial year
A3.4	Dividend income	Income statement	Dividend income from investments in equities and funds not consolidated in the financial institution's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures
A3.5	Other operating income	Income Statement	Income from ordinary banking operations not included in other BI items but of similar nature (income from operating leases should be excluded)
A3.6	Other operating expenses	Income Statement	Expenses and losses from ordinary banking operations not included in other BI items but of similar nature and from operational risk loss events (expenses from operating leases should be excluded)
A3.7	Fee and commission income	Income Statement	Income received from providing advice and services. Includes income received by the financial institution as an outsourcer of financial services
A3.8	Fee and commission expenses	Income Statement	Expenses paid for receiving advice and services. Includes outsourcing fees paid by the financial institution for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services (e.g., logistical, IT, human resources)

A3.9	Net Financial P&L	Income Statement	Net profit or loss on trading assets and trading liabilities (e.g. derivatives, debt securities, equity securities, loans and advances, short positions, other assets and liabilities), net profit/loss on financial assets and liabilities measured at fair value through profit and loss, realised gains/losses on financial assets and liabilities not measured at fair value through profit and loss (e.g. loans and advances, assets available for sale, assets held to maturity, financial liabilities measured at amortised cost), net profit/loss from hedge accounting, and net profit/ loss from exchange differences

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Appendix 4

Islamic Financial Transactions

1) Islamic financial transactions can generally be classified into four main categories as follows:

   a) Asset-based transactions, which comprise of ***Murabaha***, ***Salam*** and ***Istisna*** contracts, that are mainly structured or created based on the purchase or sale of assets,

   b) Lease-based transactions, which comprise of ***Ijārah*** contracts,

   c) Equity-based transactions, which comprise of ***Musharakah*** and ***Mudarabah*** contracts, that are undertaken mainly based on equity participation in a joint venture or business enterprise, and

   d) Loan-based transactions, which are primarily undertaken through the ***Qardh*** contract.

2) The innovation in Islamic banking products and financial instruments has resulted in the development of varied product structures which are differentiated by a unique product name.

3) For RWA_{CRED} computation purposes, the risk weights on these financial instruments shall be assessed based on the analysis of the risk profile embedded within these transactions rather than the product name, unless specifically required by the CBS. Contracts with similar transaction characteristics must be treated in the same way.

MURABAHA

4) Refers to an agreement whereby the Islamic Commercial Bank (ICB) sells to an obligor an asset that it has acquired at an agreed selling price between both parties. The selling price is based on the acquisition cost (purchase price plus other direct costs) and an agreed profit margin. The ***Murabaha*** contract shall include the agreed repayment terms where the obligor is obliged to pay the selling price after taking delivery of the asset.

5) ICBs are exposed to credit risk in the event that the obligor fails to pay the agreed selling price in accordance with the agreed repayment terms. Hence, the ICB shall be subject to the capital charge for credit risk exposure once the asset is sold and payment is due to the ICB.

Murābahah for Purchase Orderer (MPO)

6) A ***Murabahah for Purchase Orderer (MPO)*** contract refers to an agreement whereby an ICB sells to an obligor at an agreed selling price, a specified type of asset that has been acquired by the ICB based on an agreement to purchase by the obligor, which can be binding or non-binding. The relevant legal recourse provided under the contract that requires the obligor to perform their obligation to purchase the underlying asset from the ICB shall be a key determinant for the agreement to purchase to be recognised as binding or non-binding.

7) The difference between a Murābahah transaction and an MPO transaction is that under a Murābahah contract, the ICB sells an asset which is already in its possession, whilst in an MPO, the ICB acquires an asset in anticipation that the asset will be purchased by the obligor. ICBs are exposed to credit risk in the event that the obligor fails to pay the agreed selling price in accordance with the agreed repayment terms under the MPO contracts. Hence, ICBs shall be subject to the capital charge for credit risk exposure once the asset is sold and payment is due to the ICBs.

8) For MPO with binding agreement to purchase, ICBs are exposed to credit risk in the event that the obligor (purchase orderer) defaults on its binding obligation to purchase the assets under the contract. In view of the adequate legal recourse that requires the obligor to purchase the asset at an agreed price, the credit risk exposure commences once the ICB acquires the underlying asset. For non-binding MPO, the effect is similar to a Murābahah transaction.

9) The following table summarises the treatment for the determination of risk weights for the RWA_{CRED} on ***Murabaha*** and ***MPO*** contracts:

Contract	**Applicable Stage of the Contract** (When ICBs start providing for capital)	**Risk Weight**
Non-binding Murabahah for Purchase Orderer (MPO)	When asset is acquired by ICB and the sale is not completed yet (asset available for sale on financial institution´s balance sheet)[1]	187.5%*
	When sale of asset is completed and payment is due from the obligor, when the obligor is a natural person	75%**
	When sale of asset is completed and payment is due from the obligor, when the obligor is an enterprise	**100%****
Binding Murabahah for Purchase Orderer (MPO)	When asset is acquired by ICB and the sale is not completed yet (asset available for sale on financial institution´s balance sheet)[2]	100%***
	When sale of asset is completed and payment is due from the obligor, when the obligor is a natural person	75%**
	When sale of asset is completed and payment is due from the obligor, when the obligor is an enterprise	100%**

1 Includes assets which are in possession due to cancellation of agreement to purchase by customers.

2 Includes assets which are in possession due to cancellation of agreement to purchase by customers.

*Exposure is equivalent to the market value of the asset.

**Exposure is based on outstanding amount of the inventory.

*** Exposure is equivalent to the asset acquisition cost of the inventory.

SALAM

10) A ***Salam*** contract refers to an agreement whereby an ICB purchases from an obligor a specified type of commodity, at a predetermined price, which is to be delivered on a specified future date in a specified quantity and quality. The ICB makes full payment of the purchase price upon execution of the contract, and is therefore exposed to credit risk in the event that the obligor (commodity seller) fails to deliver[3] the commodity as per the agreed terms.

11) In addition, an ICB may also enter into a parallel ***Salam*** contract, which is a back-to-back contract to sell the commodity purchased under the initial ***Salam*** contract to another counterparty. This arrangement enables the ICB to mitigate the risk of holding the commodity.

12) ICBs undertaking the parallel ***Salam*** transaction are exposed to credit risk in the event that the purchaser fails to pay for the commodity it had agreed to purchase from the ICB. Nevertheless, in the event of non-delivery of the commodity by the seller under the initial ***Salam*** contract, the ICB is not discharged of its obligation to deliver the commodity to the purchaser under the parallel ***Salam*** contract.

13) For the purpose of computing RWA_{CRED}, the purchase price paid by ICB to the seller of commodity in a ***Salam*** contract shall be assigned a risk weight based on the seller's legal personality (e.g government, natural person, or enterprise).

3 Delivery risk in a ***Salam*** contract is measured based on the commodity seller's credit risk.

14) The following table summarises the treatment for the determination of risk weights for the RWA_{CRED}:

Contract	**Applicable Stage of the Contract** (When ICBs start providing capital)	**Risk Weight**
Salam	ICB is expecting delivery of the commodity after purchase price has been paid to seller. Note: Exposure amount is equivalent to the payment made by ICB	If the seller is government 0%, If the seller is a natural person 75%, If the seller is a enterprise 100%
	Receipt of the purchased commodity by the ICB	187.5%
Salam with Parallel *Salam*	ICB is expecting payment for the commodity and has to deliver the commodity (The Parallel *Salam* does not extinguish requirement for capital from the first Salam contract)	If the purchaser is government 0%, If the purchaser is a natural person 75%, If the purchaser is a enterprise 100%

ISTISNA

15) An ***Istisna*** contract refers to an agreement to sell to or buy from an obligor an asset which has yet to be manufactured or constructed. The completed asset shall be delivered according to the buyer's specifications on a specified future date and at an agreed selling price as per the agreed terms.

16) As a seller of the asset under the ***Istisna*** contract, the ICB is exposed to credit risk in the event that the obligor fails to pay the agreed selling price, either during the manufacturing or construction stage, or upon full completion of the asset.

17) As a seller, the ICB has the option to manufacture or construct the asset on its own or to enter into a parallel ***Istisna*** contract to procure the asset from another party or, to engage the services of another party to manufacture or construct the asset. Under the parallel ***Istisna*** contract, as the purchaser of the asset, the ICB is exposed to credit risk in the event that the seller fails to deliver the specified asset at the agreed time and in accordance with the initial ***Istisnā*** buyer's specifications. The failure of delivery of completed asset by the parallel ***Istisna*** seller does not discharge the ICB from its obligations to deliver the asset ordered by the obligor under the initial ***Istisna*** contract. Thus, the ICB is additionally exposed to the potential loss of completing the manufacture or construction of the asset; or acquiring the specific asset elsewhere.

18) The following table specifies the treatment for the determination of risk weights for the RWA_{CRED} on ***Istisnā*** contracts:

Contract	**Applicable Stage of the Contract** (When ICBs start providing capital)	**Risk Weight**
Istisna with Parallel *Istisna*	Istisna contract is signed or construction or manufacture of asset completed but asset not conveyed to purchaser	0%, If the counterparty is government, 75%, if the counterparty is a natural person or 100%, if the counterparty is an enterprise - of contract price
	Asset conveyed to purchaser – payment to be received in periodic instalments	0%, If the purchaser is government 75%, If the purchaser is a natural person 100%, If the purchaser is a enterprise

IJARAH

19) Contracts refer to a lease agreement whereby the lessor transfers the right to use the leased asset to the lessee, for an agreed period and at an agreed consideration, in the form of lease rental. The lessor maintains ownership of the leased asset during the lease period under these contracts.

20) As the owner of the leased asset, ICBs assume all liabilities and risks pertaining to the leased asset including the obligation to restore any impairment and damage to the leased asset arising from wear and tear, as well as natural causes which are not due to the lessee's misconduct or negligence.

21) As a lessor, ICBs may acquire the asset to be leased based on the lessee's specifications as stipulated under the agreement to lease (AL), prior to entering into the *Ijarah* contract with the lessee. The AL can be binding or non-binding on the lessee, depending on the legal recourse in the AL, which states the obligation for the lessee to lease the specified asset from the lessor.

22) ICBs as the lessor under the *Ijarah* contracts are exposed to the credit risk of the lessee in the event that the lessee fails to pay the rental amount as per the agreed terms. In addition, under a binding AL, ICBs are exposed to credit risk in the event that the lessee (lease orderer) defaults on its obligation to execute the *Ijarah* contract. In this situation, the ICB may lease or dispose of the asset to another party. However, the ICB is also exposed to the credit risk of the lessee if the lessee is not able to compensate for the losses incurred arising from the disposal of the asset.

23) Under a non-binding AL, the ICB is not exposed to the risk of non-performance by the lease order, given that the ICB does not have legal recourse to the lease orderer. In this regard, credit risk exposure arises on the commencement of the rental agreement.

24) The following table summarises the treatment for the determination of risk weights for the RWA_{CRED} on *Ijarah* contracts for the lessee:

Contract	Applicable Stage of the Contract (When ICBs start providing capital)	Risk Weight
Non-Binding Ijarah (without Agreement to Lease)	Asset available for lease (prior to signing the lease contract)*	187.5%
	After signing the lease contract - Lease rental payments due from the lessee**	If the lessee is government 0%, If the lessee is a natural person 75%, or If the lessee is a enterprise 100%
Binding Ijarah (with Agreement to Lease)	Asset available for lease (prior to signing the lease contract)***	If the lessee is government 0%, If the lessee is a natural person 75%, or If the lessee is a enterprise 100%
	After signing the lease contract - Lease rental payments due from the lessee**	If the lessee is government 0%, If the lessee is a natural person 75%, or If the lessee is a enterprise 100%

*Exposure based on the reposition cost of the asset

**Exposure based on the total outstanding principal amount plus accrued profit due from lessee

***Exposure based on the acquisition cost of the asset

MUSHARAKAH

25) *Musharakah* contract is an agreement between an ICB and its obligor to contribute an agreed proportion of capital funds to an enterprise or to acquire ownership of an asset or real estate. The proportion of the capital investment may be on a permanent basis or, on a diminishing basis where the obligor progressively buys out the share of the ICB (thus, this contract is named Diminishing *Musharakah*). Profits generated by the enterprise or an asset or real estate are shared in accordance to the terms of the agreement, while losses are shared based on the capital contribution proportion.

26) In general, *Musharakah* contracts can broadly be classified into two categories as follows:

a) Equity participation in a private commercial enterprise to undertake business ventures or financing of specific projects; or

b) Joint ownership in an asset or real estate.

EQUITY PARTICIPATION IN A PRIVATE COMMERCIAL ENTERPRISE TO UNDERTAKE BUSINESS VENTURES OR FINANCING OF SPECIFIC PROJECTS

27) An ICB may enter into a *Musharakah* contract with their obligor to provide an agreed amount of capital for the purpose of participating in the equity ownership of an enterprise. In this arrangement, the ICB is exposed to capital impairment risk in the event that the business activities undertaken by the enterprise incur losses. The *Musharakah* agreement may provide an agreed 'exit mechanism' which allows partners to divest their profit in the enterprise at a specified tenor or at the completion of the specified project. In this regard, the ICB must ensure that the contract clearly stipulates the exit mechanism for partners to redeem their investment in this entity.

28) ICBs that enter into this type of *Musharakah* contract are exposed to the risk similar to an equity holder or a joint venture arrangement where the losses arising from the business venture are to be borne by the partners. As an equity investor, the ICB serves as the first loss absorber and its rights and entitlements are subordinated to the claims of creditors. In terms of risk measurement, the risk exposure to an enterprise may be assessed based on the performance of the specific business activities undertaken by the joint venture as stipulated under the agreement.

JOINT OWNERSHIP IN AN ASSET OR REAL ESTATE

29) *Musharakah* contracts that are undertaken for the purpose of joint ownership in an asset or real estate may generally be classified into the categories as follows:

a) *Musharakah* contract with an *Ijarah* sub-contract

Partners that jointly own an asset or real estate may undertake to lease the asset to third parties or to one of the partners under an *Ijarah* contract and therefore generate rental income to the partnership. In this case, the risk profile of the *Musharakah* arrangement is essentially determined by the underlying *Ijarah* contract. ICBs are exposed to credit risk in the event that the lessee fails to service the lease rentals.

b) *Musharakah* contract with a *Murabaha* sub-contract

As a joint owner of the underlying asset, ICBs are entitled to a share of the revenue generated from the sale of asset to a third party under a *Murabaha* contract. ICBs are exposed to credit risk in the event the buyer or counterparty fails to pay for the asset sold under the *Murabaha* contract.

c) Diminishing *Musharakah*

An ICB may enter into a Diminishing *Musharakah* contract with an obligor for the purpose of providing financing based on a joint ownership of an asset, with the final objective of transferring the ownership of the asset to the obligor in the contract. The contract allows the obligor to gradually purchase the ICB's share of ownership in an asset, real estate or equity in an enterprise over the life of the contract under an agreed repayment terms and conditions which reflect the purchase consideration payable by the obligor to acquire the ICB's share of ownership.

30) As part of the mechanism to allow the obligor to acquire the ICB's share of ownership, the ICB and obligor may agree to lease the asset or real estate to the obligor. The agreed amount of rental payable can be structured to reflect the progressive acquisition of the ICB's share of ownership by the obligor. Eventually, the full ownership of the asset will be transferred to the obligor as it continues to service the rental payment. In this regard, the ICB is exposed to credit risk similar to an exposure under the *Musharakah* with *Ijarah* contract.

31) However, if the exposure under the Diminishing *Musharakah* contract consists of share equity in an enterprise, the ICB shall measure its risk exposure using the treatment for equity risk.

32) The following table specifies the treatment for the determination of risk weights for the RWA_{CRED} on *Musharakah* contracts:

Contract	**Applicable Stage of the Contract** (When ICBs start providing capital)	**Risk Weight**
Musharakah for equity holding	Holding of equity	400% risk weight of equity held
Musharakah with sub- contract	Joint ownership	0%, if the sub- contract counterparty is a government 75% if the sub- contract counterparty is a natural person or 100% if the sub- contract counterparty is a enterprise

MUDĀRABAH

33) ***A Mudarabah*** contract is an agreement between an ICB and an obligor whereby the ICB contributes a specified amount of capital funds to an enterprise or business activity that is to be managed by the obligor as the entrepreneur ***(Mudarib).*** As the capital provider, the ICB is at risk of losing its capital investment (capital impairment risk) disbursed to the *Mudarib*. Profits generated by the enterprise or business activity are shared in accordance with the terms of the *Mudarabah* agreement whilst losses are borne solely by the ICB (capital provider)[4]. However, losses due to misconduct, negligence or breach of contracted terms[5] by the entrepreneur, shall be borne solely by the *Mudarib*. In this regard, the amount of capital invested by the ICB under the *Mudarabah* contract shall be treated similar to an equity exposure.

34) *Mudarabah* transactions can be carried out:

a) on a restricted basis, where the capital provider authorises the *Mudarib* to make investments based on a specified criteria or restrictions such as types of instrument, sector or country exposures; or

b) on an unrestricted basis, where the capital provider authorises the *Mudarib* to exercise its discretion in business matters to invest funds and undertake business activities based on the latter's skills and expertise.

35) In addition, transactions involving *Mudarabah* contracts may generally be sub-divided into two categories as follows:

a) PRIVATE COMMERCIAL ENTERPRISE TO UNDERTAKE BUSINESS VENTURES

This type of *Mudarabah* contract exposes the ICB to risks akin to an equity investment, which is similar to the risk assumed by an equity holder in a venture capital or a joint-venture investment. As an equity investor, the ICB assumes the first loss position and its rights and entitlements are subordinated to the claims of creditors.

b) INVESTMENT IN PROJECT FINANCE[6]

The ICB's investment in the *Mudarabah* contract with a *Mudarib* is for the purpose of providing bridging finance to a specific project. This type of contract exposes the ICB to capital impairment risk in the event that the project suffers losses. Under this arrangement, the ICB as an investor provides the funds to the construction company or *Mudarib* that manages the construction project and is entitled to share the profit of the project in accordance to the agreed terms of the contract and must bear the full losses (if any) arising from the project.

4 Losses borne by the capital provider would be limited to the amount of capital invested.

5 Banking institutions are encouraged to establish and adopt stringent criteria for definition of misconduct, negligence or breach of contracted terms.

6 Project finance refers to the method of funding in which the lender looks primarily to the revenues generated by a single project, usually for large, complex and expensive installations, both as the source of repayment and as security for the loan. It can take the form of financing the construction of a new installation or refinancing an existing installation.

36) The following table summarises the treatment for the determination of risk weights for the RWA_{CRED} on *Mudarabah* contracts:

Contract	**Exposure to be considered** (When ICBs start providing capital)	**Determination of Risk Weight**
Mudarabah for *Private Commercial Enterprise*	Amount to the business venture ***less*** any specific provisions	400% risk weight for equity
Mudarabah for project financing	Amount receivable from *Mudarib* in respect of progress payments due from ultimate obligors	***150%*** risk weight
	Remaining balance of funds advanced to the *Mudarib* .	100% risk weight[7]

QARDH

37) Qardh is a loan given by a financial institution for a fixed period, where the borrower is contractually obliged to repay only the principal amount borrowed. In this contract, the borrower is not obligated to pay an extra amount (in addition to the principal amount borrowed) at his absolute discretion as a token of appreciation to the ICB. ICBs are exposed to credit risk in the event that the borrower fails to repay the principal loan amount in accordance to the agreed repayment terms. Hence, the credit risk exposure commences upon the execution of the ***Qardh*** contract between the ICB and the borrower.

38) The following table summarises the treatment for the determination of risk weights for the RWA_{CRED} on ***Qardh*** contract:

Applicable Stage of the Contract	Determination of Risk Weight
Upon execution of the contract and ICBs start providing capital	Risk weight is based on obligor's legal personality: If the counterparty is government 0% If the counterparty is an enterprise 100% If the counterparty is a natural person 75%

7 The financial institution should increase the risk weight if the risk profile of the exposure is deemed higher.

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