Central Bank of Oman

ISLAMIC BANKING
REGULATORY FRAMEWORK
Islamic Banking Regulatory Framework

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1. Introduction

1.1 Scope of Coverage

1.1.1 These licensing rules and guidance apply to full-fledged domestic Islamic banks, Islamic banking branches, in Oman, of foreign banks and Islamic Windows of domestic conventional banks, all together called “Licensees” hereunder and regulated and supervised by the Central Bank of Oman (“Central Bank”).

1.1.2 Islamic Windows will take the form of a branch or cluster of branches.

1.2 General Requirements

1.2.1 Persons wishing to be licensed to undertake Islamic banking business, as authorised hereunder, within or from the Sultanate of Oman (“Oman” or “Sultanate”), must apply in writing to the Central Bank.

1.2.2 Each Licensee shall display the respective licenses at all times in a conspicuous place in all its offices.

1.3 General Prohibitions

1.3.1 No person shall engage in authorized banking business in the Sultanate unless such a person has been granted a license, as under, by the Central Bank provided, however, that institutions other than Licensees may engage in authorised banking business except accepting deposits and managing investment accounts, subject to those institutions being authorised and regulated pursuant to the laws of the Sultanate by a recognised regulator.¹

1.3.2 It shall be unlawful for any person other than licensed banks, meaning to include Licensees, to use the word “bank” or “banking” in its name and undertake or imply by advertising or otherwise that it is engaged in banking business requiring to be licensed / authorised, provided, however, that a foreign institution may use its name and publicize its business activities if such use and publicity clearly establish that such foreign institution does not engage in the banking business within the Sultanate. Licensed financial institutions may, however, advertise the banking business they are authorized to engage in by the Central Bank.²

1.3.3 Penal and other relevant provisions in place, in this connection, from time to time under the Banking Law and other laws of Oman, shall apply.
1.4 **Shari’a Compliant business**

1.4.1 A Licensee shall conduct all of its activities, operations and transactions in accordance with Shari’a rules and principles.

1.4.2 Licensees desiring to do investment banking business shall have investment banking license, as stated in Chapter 5 of this Title, complying with the prescribed set of requirements and conditions. Such business shall also be Shari’a compliant.
2. **Authorized Islamic Banking Business**

2.1 **Accepting Deposits**

2.1.1 This refers to the acceptance of money for safe keeping based on Islamic contracts.

2.1.2 The amount shall be repaid by the Licensee to the depositor either on demand or upon maturity, as mutually agreed.

2.2 **Managing Unrestricted Investment Accounts (URIAs)**

2.2.1 Investment Account Holders (“IAHs”) authorize the Licensee to invest their funds on the basis of an Islamic contract (e.g. Mudaraba) in a manner which the Licensee deems appropriate without imposing any restrictions as to where, how and for what purpose the funds should be invested.

2.3 **Managing Restricted Investment Accounts (RIAs)**

2.3.1 IAHs authorize the Licensee to invest their funds on the basis of an Islamic contract (e.g. Mudaraba) and impose certain restrictions on the Licensee as to where, how and for what purpose the funds should be invested.

2.4 **Providing Islamic Finance Products**

2.4.1 Providing Islamic finance products means entering into or making arrangement for another person to enter into a contract to provide a financing product in accordance with Shari’a rules and principles.

2.4.2 *Islamic finance contracts include Mudaraba, Musharaka, Diminishing Musharaka, Murabaha, Musawama, Salam, Istisna’a and Ijarah, among others. Attachment 9.1 provides a brief about the basic features of standard Islamic finance contracts.*

2.4.3 Commodity Murabaha or Tawarruq, by whatever name called, is not allowed for the Licensees in the Sultanate as a general rule. Reference may be made to the Title on Liquidity Risk for a detailed discussion on Commodity Murabaha.

2.5 **Providing Money Exchange / Remittance Services**

2.5.1 This means the provision of currencies exchange facilities and the provision of wire transfer or other remittance services.

2.6 **Issuing / Administering Means of Payment**
2.6.1 This means the selling or issuing of payment instruments, or the selling or issuing of stored value instruments (e.g. credit cards, travellers’ cheques and electronic purses).

2.7 **Other Authorized Business / Transactions**

2.7.1 Licensees may undertake Islamic banking business not listed hereunder and activities and transactions incidental to Islamic banking business, subject to specific approvals and conditions set.

2.7.2 Licensees should make reference to the Central Bank in case of any clarification needed.
3. Licensing Requirements

3.1 Legal Status

3.1.1 The legal status of a domestic full-fledged Islamic bank must be a listed Joint Stock Company.

3.1.2 In case the Licensee is a branch of a foreign bank, the Central Bank will consider, among others, its constitution and control set up and activities, besides extent of home country regulation / supervision in compliance with Basel Core Principles for Effective Banking Supervision and Financial Action Task Force (“FATF”) recommendations.

3.2 Ownership / Shareholdings

3.2.1 The aggregate holding by an individual and his related parties shall not exceed 15% of the voting shares in a domestic bank.

3.2.2 The aggregate holding by an incorporated body and its related parties shall not exceed 25% of the voting shares in a domestic bank.

3.2.3 The aggregate holding by a joint stock company or a holding company and its related parties shall not exceed 35% of the voting shares in a domestic bank.

3.2.4 No individual who together with any related party already owns 10% or more of the voting shares of a domestic bank shall own by way of investment more than 15% of the outstanding voting shares of another domestic bank.

3.2.5 For the purpose of the above requirement, “Company” means any Joint Stock Company or Holding Company established under the Commercial Companies Law of 1974 as amended, “Incorporated body” means any Commercial or any incorporated body other than a Joint Stock Company or a Holding Company and “Related Party” means spouse or dependent children, any Company or incorporated body wherein an individual or his spouse or his dependent children or any other company or incorporated body invests 35% or more.

3.2.6 If a company or incorporated body owns the maximum shareholding of voting shares in a domestic bank, in such case, any other company or incorporated body having such shareholding in the first mentioned company or incorporated body shall not own any voting shares in that bank.3

3.2.7 There shall be no ownership or transfer of more than ten percent of voting shares by a person or group of persons acting individually or jointly for a common purpose without approval of the Central Bank.4

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3.2.8 No commercial company or business entity owning ten or more percent of voting shares in a licensed bank shall merge or effect consolidation with any other business entity or have in excess of 25% of its shares transferred to any one person or group of persons acting jointly or to a common purpose without the approval of the Central Bank.  

3.3 **Senior Management Personnel**

3.3.1 The Central Bank’s approval is needed for the appointment of senior management personnel.  

3.3.2 Senior Management shall mean the following:  

3.3.2.1 Chief Executive Officer (CEO) / General Manager (GM);  

3.3.2.2 Deputy / Assistant General Manager; and  

3.3.2.3 Country Manager (or equivalent) of a foreign Licensee.  

3.3.3 Licensees’ senior management personnel shall meet the following “Fit & Proper Criteria”:  

3.3.3.1 Not been convicted for any crime, unless cleared by a judicial authority;  

3.3.3.2 Not committed an offense involving fraud or other dishonesty or violence;  

3.3.3.3 Not acted in contravention of any statute of Oman or any provisions established for the purpose of protecting members of the public from financial loss due to dishonesty, incompetence or malpractice by the person concerned;  

3.3.3.4 Not been involved in any deceptive or oppressive practices which would cast doubt on their integrity and on the business; and  

3.3.3.5 Not been involved or associated with any other business practices that can cast doubt on their competence and soundness of judgment.  

3.3.4 Senior management personnel of the Licensees must fulfil all the criteria mentioned above in addition to having adequate knowledge of Islamic banking contracts, products, processes and Shari’a principles, particularly relevant to their responsibilities.  

3.3.5 Licensees shall look into the previous conduct and activities of senior management personnel and take into account the other positions held by such persons and their qualifications and experience, when confirming conformity with fit & proper criteria and recommending the proposed appointments to the Central Bank for approval.
3.3.6 The Central Bank may object to the proposed appointments if it considers that such appointments may be detrimental to the interests of the depositors / Investment Account Holders / Licensee.

3.3.7 Even if Head of Internal Audit of a domestic full-fledged Islamic bank and Head of Islamic banking in a Licensee may not be part of senior management cadres, the Licensee shall ensure their adherence with the above criteria and approval requirements.

3.3.8 Licensees, when submitting detailed request for approval, shall also submit specified bio-data form duly completed.8

3.3.9 Licensees, particularly domestic full-fledged Islamic banks, shall assign important positions such as Heads of Audit, Compliance and Risk Management to appropriate senior management cadres, commensurate with the size and sophistication of their operations and significance of responsibilities, complying with all applicable requirements.

3.3.10 The Board of Governors, within its discretion, may displace any of the Chief Executive Officers, General Managers or senior management personnel by a detailed note to safeguard the depositors, Investment Account Holders and/or net worth interests.9

3.4 **Board of Directors**

3.4.1 General

3.4.1.1 No Chief Executive Officer, General Manager or employee of a domestic bank shall hold simultaneously directorships in the boards of directors of such banks.

3.4.1.2 No domestic bank shall appoint to its board of directors any person who is already a member of the board of directors of another bank.10

3.4.1.3 A person who is a director in a domestic bank is not eligible for / entitled to be a director in another bank and consequently he cannot appoint somebody else as proxy in the latter. In other words, a director in a domestic bank’s board cannot seek / find representation in another bank’s board of directors directly or through proxy.

3.4.1.4 Quasi-government entities like Pension Funds are exempted from the provision of disallowing their representatives, as above, in more than one domestic bank, subject to the following conditions:

3.4.1.4.1 Such bodies shall not appoint the same person to represent them in more than one board of directors; and
3.4.1.4.2 Each such proxy shall cease to be a member of the board of directors if and when he/she avails credit facilities from the concerned bank.

3.4.2 Suitability and Appointment of Directors

3.4.2.1 Every person who is to be a director of a domestic bank must meet the general requirements for such persons set out under the Commercial Companies Law No. 4/1974.

3.4.2.2 Central Bank shall consider the suitability of persons who are elected to act as directors of the boards.11

3.4.2.3 Central Bank shall look into the concerned person’s previous conduct and activities in business or financial matters in particular.

3.4.2.4 A director shall meet the following “Fit & Proper” criteria:

3.4.2.4.1 Not committed an offense involving fraud or other dishonesty or violence;

3.4.2.4.2 Not acted in contravention of any statute of Oman or any provisions established for the purpose of protecting members of the public from financial loss due to dishonesty, incompetence or malpractice by the person concerned;

3.4.2.4.3 Not been involved in any deceptive or oppressive practices which would cast doubt on his integrity and on the business; and

3.4.2.4.4 Not been involved or associated with any other business practices that can cast doubt on his competence and soundness of judgment.

3.4.2.5 Central Bank may also take into account the other positions held by such a person in his career, his financial solvency as well as his qualifications, experience and expertise in the area of business.

3.4.2.6 Central Bank may object to and not approve the appointment of a member of a board of directors if it considers that such appointment does not meet fit & proper criteria and may be detrimental to the management of that Licensee or to the interests of the depositors / Investment Account Holders.

3.4.2.7 The Board of Governors may, within its discretion, displace any of the directors by a detailed note to safeguard the depositors, investment account holders and/or net worth interests.12

3.4.2.8 Licensees concerned shall arrange to make submissions to the Central Bank on proposed nominations / appointments of directors well in time to enable it to consider them before hand.

3.4.2.9 Licensees concerned shall have their directors, whose accounts are classified, removed in accordance with relative provisions stated in the Title on Credit Risks.
3.5 Financial Resources

3.5.1 Initial Capital

3.5.1.1 A domestic bank shall have and at all times maintain a paid-in capital of not less than 100 Million Rials Omani (“RO”) or such higher amount as may be determined from time to time by the Central Bank.

3.5.1.2 A foreign bank shall have and at all times maintain within the Sultanate an assigned capital of not less than RO 20 Million as initial capital or such higher amount as may be determined from time to time by the Central Bank.

3.5.1.3 An Islamic Window shall have and at all times maintain an allocated capital of not less than RO 10 Million or such higher amount as may be determined from time to time by the Central Bank.

3.5.1.4 Capital requirement for Windows will be in addition to the minimum stipulated capital requirement of the concerned licensed bank.

3.5.1.5 A foreign bank, not operating in Oman and seeking to commence Islamic banking in Oman, will have minimum assigned capital of RO 20 million. A foreign bank, already operating in Oman and seeking to open Islamic banking branches, shall assign minimum of RO 10 million for these branches over and above the minimum capital requirement of RO 20 million.

3.5.1.6 Windows will be constrained in capital adequacy norms based upon net worth reckoned upon the allocated capital, and the bank concerned shall have this net worth reduced from its net worth for its limitation, as stated in 3.5.3.3 below. Windows’ capital allocation will preferably be sufficient to cover projected losses in the initial years, if any, besides maintaining the minimum capital allocation of RO 10 million at all times.

3.5.1.7 Foreign banks’ Islamic banking branches in Oman shall be constrained in leveraging by net worth determined based upon capital assigned to them as in the case of Windows.

3.5.2 Capital Deposits

3.5.2.1 The capital deposit of a Licensee shall be equivalent to one-tenth of one percent of all the banking resources of the business entity, corporation or other business combination which includes the subject Licensee, as computed annually by the Central Bank on the audited financials of the concerned institution.

3.5.2.2 Windows shall have no capital deposit requirement since it will be covered by the parent.
3.5.2.3 Foreign banks, having branches already and commencing Islamic banking branches, shall have no additional capital deposit requirement.

3.5.2.4 The minimum capital deposit shall be RO 50,000 and the maximum amount shall be RO 500,000.

3.5.2.5 Capital deposit amount, initially, shall be required to be made before commencement of business and shall be adjusted on an annual basis in relation to audited financials as in 3.5.2.1 above.

3.5.2.6 Any excess in the amount of the capital deposit shall be paid to the Licensee by the Central Bank and shortfall met by the concerned Licensee.

3.5.3 Capital Adequacy

3.5.3.1 Capital adequacy for Islamic banks is unique in some aspects because the features of Islamic finance contracts require a thorough evaluation of the degree of associated risks.

3.5.3.2 Details of the capital adequacy requirement in relation to Islamic banking are provided in the Title on Capital Adequacy.

3.5.3.3 Capital Adequacy reckoning for Windows and foreign banks’ Islamic banking branch(es) in Oman shall be related to their net worth, as determined based upon capital assigned / allocated to them and other permissible factors. The concerned Licensee will reduce such net worth from its position for the purpose of leveraging limitation for residual operations.

3.6 Reserves Against Deposits

3.6.1 The Central Bank may require Licensees to maintain reserves with the Central Bank.

3.6.2 The amount of reserves required shall not be more than 40% of the total daily amount of all deposits and Unrestricted Investment Accounts made with them within the Sultanate.

3.6.3 The percentage of the total amount of reserves required shall be adjusted, from time to time, by the Central Bank.

3.6.4 The reserves shall be in RO and shall not yield any returns.

3.6.5 Any shortage in the required reserves, which exists at the close of any monthly computation period, shall be cured by depositing with the Central Bank the amount, as stipulated, to cure such shortage not later than the tenth business day following the close of such monthly computation period.\textsuperscript{13}
3.6.6 Reserves will be maintained at 5% of deposits and unrestricted investment accounts, resident and non-resident and excluding domestic interbank, in the form of clearing account balances. This percentage may be changed by the Central Bank from time to time.

3.7 **Reserves for the Protection of depositors / IAHs**

3.7.1 The Central Bank may require Licensees to maintain reserves within the Sultanate in an amount equal to the greater of:

3.7.1.1 The aggregate amount of capital deposit required;

3.7.1.2 Not more than 15% of the total daily amount of deposits and Unrestricted Investment Accounts.

3.7.2 The amount of reserves may be adjusted, from time to time, by the Central Bank. 14

3.8 **Liquidity**

3.8.1 Licensees must maintain sufficient liquid assets to meet their obligations as they fall due in the course of their business.

3.8.2 Licensees must evolve and follow appropriate liquidity management policy, among others, complying with specific requirements stipulated in this connection in the Title on Liquidity Risk.

3.9 **Systems and Controls**

3.9.1 Applicants will be required to demonstrate in their plan of operations what risks their business would be subjected to and how they would manage those risks.

3.9.2 Applicants may, as part of license approval process or later, be asked to provide an independent assessment of the appropriateness of their systems and controls to cater for the unique requirements of Islamic contracts and products.

3.9.3 Licensees shall maintain systems and controls that are adequate for the scale and complexity of their activities and operations.

3.9.4 Licensees must maintain systems and controls that are adequate to address the risks of financial crimes, money laundering and financing of terrorism.

3.9.5 The Central Bank shall focus on the Shari’a Governance system proposed and applicant’s preparedness in general of control capability and in particular of Shari’a compliance capability in considering approvals.
3.9.6 Control environment should be reassuring in all risk management dimensions. Independence and adequacy of capacity should be ensured, avoiding conflicts in functioning. Internal Audit, for instance, should report to the Board or Audit Committee in respect of domestic Licensees.

3.9.7 *Shari’a governance requirements are covered in the Title on General Obligations and Governance.*

### 3.10 External Auditor

3.10.1 Applicants must submit details of their proposed external auditors to the Central Bank as part of their license application.

3.10.2 The Licensee must appoint an external auditor, subject to the Central Bank’s prior approval.

3.10.3 The minimum requirements regarding external auditors, covered in the Title on Accounting Standards and Auditor Reports, must be met.

3.10.4 External auditors, as part of their review, shall certify that separate controls and systems have been maintained, among others, to ensure that in the case of the Islamic Window there is no commingling of funds with the conventional parent.

### 3.11 Books of Accounts

3.11.1 Licensees must maintain comprehensive books of accounts and other records.

3.11.2 Separate books of accounts shall be maintained for an Islamic Window.


### 3.12 Shari’a Supervisory Board

3.12.1 As part of the licensing requirements, applicants shall inform the Central Bank of the names, qualifications and experience of the members of their Shari’a Supervisory Board (“SSB”), complying with related requirements stated in the Title on General Obligations and Governance.

### 3.13 Other Requirements
3.13.1 Licensees and their staff must act in an open and cooperative manner with the Central Bank.

3.13.2 Licensees must conduct their activities in a professional and orderly manner, in keeping with good market practices.

3.13.3 Licensees shall submit to the Central Bank, on an annual basis, their Islamic banking training programs for the management, Shari’a resources and board of directors.

3.13.4 Licensees shall have dedicated treasurer / senior trader for managing Shari’a compliant instruments for their treasury function.

3.13.5 Organisational control requirements and guidance have been provided in the Title on General Obligations and Governance.

3.13.6 Support function arrangements, if outsourced by the Licensees from third parties / their parents, shall be agreed with Shari’a Supervisory Board and then reported to the Central Bank.

3.13.7 An Islamic Window shall only operate through separate Islamic banking-only branches and they shall be dedicated to offering Islamic products and services only. Foreign Licensees shall also comply with this.

3.13.8 Licensees shall have separate front office staff for dealing with customers, ensuring required competence.

3.13.9 No Islamic products / services shall be offered through conventional branches.

3.13.10 Exceptions to 3.13.9 may be provided as one-off services in conventional bank branches, proposed to be availed at the customer’s option and with no lead from the Licensee, like cash withdrawal and deposit of cheques for credit of accounts with Islamic banking Windows / branches provided the Licensee ensures that there is no commingling of funds, conventional bank branches shall not initiate / conduct Islamic banking account relationship and other services, there is adequate IT and other enabling requirement for compliance and that possible customer contact in the process is not used in those branches for any business purposes whatsoever directly or indirectly.

3.13.11 Licensees shall ensure at all times that all their staff conform to fit & proper and suitability requirements including those of Islamic banking, as relevant to their job profiles and customer interface.
4. Licensing Process

4.1 Application Process – Domestic Banks

4.1.1 An application for a license process must be in line with the form prescribed by the Central Bank.

4.1.2 The application process for domestic banks will involve the following steps:

4.1.2.1 Filing a request letter - domestic banks

4.1.2.1.1 It is recommended that the representative of the founders of the proposed domestic bank files a letter of request initially listing the founders and shareholding pattern, highlighting their background and providing justification for their interest in opening the bank, business vision, plans, strategies and business focus.

4.1.2.2 Filing a formal request for initial approval - domestic banks

4.1.2.2.1 Formal application from the Chairman of the Founding Committee or the authorized person representing at least 60% of the proposed capital along with list of shareholders proposing to hold 5% or more of such capital;\textsuperscript{15}

4.1.2.2.2 Audited financial reports / net worth statements of significant shareholders for the last three years;

4.1.2.2.3 Detailed feasibility report covering at least five years of forecast. The feasibility report shall be a comprehensive and professionally prepared report, in detail, covering the vision, business policies, strategies and projections, highlighting also proposed organization structure including Shari’a governance and compliance set up, risk management approaches and details, SWOT analysis, stress testing, etc.;

4.1.2.2.4 Payment of application fee of RO 5,000;\textsuperscript{16}

4.1.2.2.5 Any other requirement the Central Bank may call upon in specific circumstances.

4.1.2.3 Filing a formal request for final approval - domestic banks

4.1.2.3.1 This shall follow grant of initial approval by the Central Bank.

4.1.2.3.2 License fee of RO 5,000;\textsuperscript{17}

4.1.2.3.3 Evidence of receipt of paid up capital in the name of the bank; this shall be a minimum of RO 100 million and should preferably cover projected losses, if any, in the initial years.

4.1.2.3.4 Payment of capital deposit to the Central Bank (this will be one tenth of one percent of the global assets of the bank forecast on establishment) with minimum of RO 50,000 and maximum of RO 500,000;

4.1.2.3.5 Copy of lease agreement with lay out for head office / branch(es);
4.1.2.3.6 Letters of clearance from Royal Oman Police and fire prevention authorities for the premises;

4.1.2.3.7 List of directors and authorized officials of the bank with specimen signatures;

4.1.2.3.8 Confirmation that commercial companies law, commercial registration and municipality and other government requirements have been completed and approvals received (with copies of evidences, including commercial registration print out, as may be relevant);

4.1.2.3.9 Letter of undertaking on qualification and continuity of management;\textsuperscript{18}

4.1.2.3.10 Confirmation that staff, IT systems and all other infrastructure, internal policies and procedures, product programs and all other pre-requisites are in place and that all conditions of initial approval/licensing requirements, including Shari’a governance structure and systems, have been met;

4.1.2.3.11 The applicant should nominate a suitable official in time to liaise with all the concerned departments of the Central Bank to ensure familiarity and compliance with regards to regulatory, supervisory, operational / reporting stipulations, payment systems, Bank Credit and Statistical Bureau, cheque return system, currency and treasury requirements.

4.1.2.3.12 Draft Articles and Memorandum of Association and public offer documents should be submitted well in time for the Central Bank’s review and observations if any.

4.1.2.3.13 Details of proposed SSB members and a letter of confirmation that they are in compliance with the fit & proper criteria of the Central Bank should be submitted.

4.1.2.3.14 The Founders’ Committee should promptly keep the Central Bank apprised of the preparatory and completion progress and details including public issue.

4.1.2.3.15 Copies of the Articles and Memorandum of Association; and

4.1.2.3.16 Evidence of compliance with CMA requirements (e.g. the certified minutes of constituent meeting).

4.2 Application Process - Foreign Banks

4.2.1 This Article shall apply to foreign banks, not operating in Oman and seeking to open Islamic banking branches in Oman.

4.2.2 An application for a license process must be in line with the form prescribed by the Central Bank.

4.2.3 The application process for foreign banks will involve the following steps:

4.2.3.1 Filing a request letter - foreign banks

4.2.3.1.1 \textit{It is recommended that a foreign bank files a letter of request initially, highlighting the bank’s background (with audited financials for last three years) and providing}
justification for interest in commencing Islamic banking in Oman, business vision, plans, strategies and business focus.

4.2.3.2 Filing a formal request letter for initial approval - foreign banks

4.2.3.2.1 Formal application from the authorized official of the bank along with the list of shareholders holding 5% or more of subscribed capital and details of directors and senior staff of the bank.\(^\text{19}\)

4.2.3.2.2 Audited financial reports of the bank for the last three years;

4.2.3.2.3 Detailed feasibility report covering at least five years of forecast;

4.2.3.2.4 The feasibility report shall be a comprehensive and professionally prepared report, in detail, covering the vision, business policies, strategies and projections, highlighting organization structure including Shari’a governance and compliance set up, risk management approach and details, SWOT analysis, stress testing, etc.;

4.2.3.2.5 Payment of application fee of RO 5,000; \(^\text{20}\)

4.2.3.2.6 Copy of the bank’s board resolution, approving opening of the branch in Oman, providing authority to the signatory to sign the application and complete the application requirements and submitting assurance of head office guarantee on approval of the application;

4.2.3.2.7 Letter from the home country supervisor approving the new branch and assuring signing of Memorandum of Understanding and supervisory cooperation on approval; and

4.2.3.2.8 Any other requirement the Central Bank may call upon in specific circumstances.

4.2.3.3 Filing a formal request for final approval - foreign banks

4.2.3.4 This shall follow grant of initial approval by the Central Bank.

4.2.3.4.1 License fee of RO 5,000; \(^\text{21}\)

4.2.3.4.2 Evidence of receipt of assigned capital in the name of the branch; this shall be a minimum of RO 20 million and should also preferably cover projected losses, if any, in the initial years;

4.2.3.4.3 Payment of capital deposit to the Central Bank (this will be one tenth of one percent of the global assets of the bank with minimum of RO 50,000 and maximum of RO 500,000);

4.2.3.4.4 Letter of guarantee from head office; \(^\text{22}\)

4.2.3.4.5 Letter of confirmation from head office on availability / continuance of adequate Shari’a governance arrangements including suitability of SSB members;

4.2.3.4.6 Copy of lease agreement for the premises of the main office / branch(es);
4.2.3.4.7 Letters of clearance from Royal Oman Police and fire prevention authorities for the premises;

4.2.3.4.8 List of authorized officials of the branch(es) with specimen signatures;

4.2.3.4.9 List of authorized officials of head office (with specimen signatures) for communication with the Central Bank;

4.2.3.4.10 Confirmation that commercial companies law, commercial registration and municipality and other government requirements have been completed and approvals received (with copies of official evidences) and confirmation that conditions of initial approval and licensing requirements have been met;

4.2.3.4.11 Letter of undertaking on qualification and continuity of management; and

4.2.3.4.12 Confirmation that staff, IT systems (core banking systems should support Islamic operations), internal policies and procedures, product programs and all other pre-requisites are in place and that all the conditions of initial approval and licensing, including Shari'a governance structure and systems, have been fully met;

4.2.3.4.13 Details of proposed SSB members and a letter of confirmation that they are in compliance with the fit & proper criteria of the Central Bank should be submitted.

4.2.3.4.14 The applicant should nominate a suitable official in time to liaise with all concerned departments of the Central Bank to ensure familiarity and compliance with regards to regulatory, supervisory, operational / reporting stipulations, payment systems, Bank Credit and Statistical Bureau, cheque return system, currency and treasury requirements.

4.3 Application Process – Islamic Windows of domestic conventional banks

4.3.1 The application process for opening Islamic Windows of domestic conventional banks will involve the following steps:

4.3.1.1 Filing a request letter – Islamic Windows of domestic conventional banks

4.3.1.1.1 It is recommended the applicant files a letter of request initially, highlighting the bank’s background and providing justification for interest in opening an Islamic Window, business vision, plans, including a roadmap for the Window for at least three years, strategies and business focus.

4.3.1.1.2 The applicant will set its vision, plan and submissions on Islamic banking operations in Oman, noting that the approval on conduct of Islamic banking through Windows shall be reviewed by the Central Bank from time to time.

4.3.1.1.3 Copies of the bank’s updated Articles and Memorandum of Association;

4.3.1.1.4 Applicant has to produce evidence of authorization for conduct of Islamic banking business in Articles of Association and board of directors’ resolutions;

4.3.1.1.5 Applicant has to provide letter of assurance that Islamic and conventional sources of funds will not be commingled;
4.3.1.6 Applicant shall undertake to fulfil SSB and all other applicable requirements as stipulated by the Central Bank from time to time;

4.3.1.2 **Filing a formal request for initial approval – Islamic Windows of domestic conventional banks**

4.3.1.2.1 Formal application from the authorized official of the bank;

4.3.1.2.2 Detailed feasibility report covering at least five years of forecast;

4.3.1.2.3 The feasibility report shall be a comprehensive and professionally prepared report, in detail, covering the vision, business policies, strategies and projections, highlighting risk management approach and details, SWOT analysis, stress testing, etc. and evidencing compliance in operations; Shari’a governance and compliance set up and processes, proposed, shall be adequately covered;

4.3.1.2.4 Payment of application fee of RO 500 for each branch; and

4.3.1.2.5 Any other requirement the Central Bank may call upon in specific circumstances.

4.3.1.3 **Filing a formal request for final approval – Islamic Windows of domestic conventional banks**

4.3.1.3.1 These shall follow grant of initial approval from the Central Bank.

4.3.1.3.2 License fee of RO 500 for every branch.

4.3.1.3.3 Evidence / confirmation of allocated capital for the Window.

4.3.1.3.4 List of directors and authorized officials with specimen signatures (senior management staff and Head of Islamic Banking should get Central Bank’s prior approval);

4.3.1.3.5 Confirmation that commercial companies law, commercial registration and municipality and other government requirements have been completed and approvals received (with copies of official printouts/evidences);

4.3.1.3.6 Confirmation that staff, IT systems (core banking systems should support Islamic operations), internal policies and procedures, product programs and all other pre-requisites are in place and that all the conditions of initial approval and licensing, including Shari’a governance structure and systems, have been fully met;

4.3.1.3.7 Details of proposed SSB members and a letter of confirmation that they are in compliance with the fit & proper criteria of the Central Bank should be submitted.

4.3.1.3.8 The applicant should nominate in time a suitable official to liaise with all concerned departments of the Central Bank to ensure familiarity and compliance with regard to regulatory, supervisory, operational / reporting stipulations, payment systems, Bank Credit and Statistical Bureau, cheque return system, currency and treasury requirements etc.
4.3.1.3.9 *Foreign banks already operating in Oman and seeking to apply for Islamic banking branches in Oman, shall comply with the above processes and requirements on Windows as applicable.*

4.3.1.3.10 *Domestic conventional banks and foreign banks already operating in Oman with conventional bank branches shall have capital to meet assignment / allocation requirement for their Windows / Islamic banking branches over and above the minimum capital requirements.*

### 4.4 Application Process – Branches

4.4.1 A domestic full-fledged Islamic bank may, with the approval of the Central Bank, establish and operate Islamic banking branch offices within or outside the Sultanate.23

4.4.2 A foreign bank licensed in Oman for authorised Islamic banking business may, with the approval of the Central Bank, establish and operate one or more branches within the Sultanate.

4.4.3 The applicant concerned seeking to establish a branch office within or outside the Sultanate shall submit the following to the Central Bank:24

4.4.3.1 A request for authorization of each branch to the Central Bank in the form prescribed by the Central Bank;

4.4.3.2 A “Plan of Operations” in the form of a detailed feasibility report for at least five years, covering, but not being limited to, information concerning the types of geographical and commercial communities to be served by the applicant, the specific kind of banking business in which the Licensee intends the proposed branch to engage and the need for the particular bank or banking business in the communities to be served.

4.4.3.3 Other materials as may be prescribed by the Central Bank.

4.4.4 Licensee shall pay application fee and license fee of RO 500 each per every additional branch within the Sultanate and complete the licensing requirements.

4.4.5 Licensee concerned shall pay application fee of RO 2,500 and RO 500 for the first and each of subsequent branches respectively in each foreign country.

4.4.6 *The Central Bank’s consideration of domestic banks’ applications, proposing to open branches abroad, shall depend upon licensing policy and circumstances relevant to the time.*

### 4.5 Review and Approval of the Application

4.5.1 The Central Bank will review the license application for domestic banks and advise the applicants in writing about its decision within 120 days of receipt of application complete in all respects.
4.5.2 The Central Bank shall review the request for authorization and shall grant approval if, in its discretion, it believes that the proposal will contribute to the economic needs of the community to be served and that the applicant has the banking, managerial and economic resources to accommodate branch expansion and meet applicable conditions and norms.

4.5.3 Approval or disapproval of any request for authorization of a branch office / Islamic Window shall be made by the Central Bank within 90 days from the date the application is submitted complete in all respects.

4.5.4 General considerations of requests of all applications shall include applicant’s financial strength and various resources, present and prospective, governance and management, record of past performance and business including asset quality and movements therein, compliance, examination and other ratings and similar material parameters. Capacity, competence and preparedness for Shari’a compliance shall receive special attention.

4.5.5 When the Central Bank conveys its initial approval, it may specify special conditions, if any, to be fulfilled in addition to the following:

4.5.5.1 The branch shall mobilize reasonable deposits / Investment Accounts in the area itself for its grant of financing facilities. Adequate financing powers shall be given to the manager;

4.5.5.2 When seeking final approval and license for a branch, the Licensee shall provide the Curriculum Vitae of the proposed manager, who shall be an Omani national.

4.6 Commencement of Banking Activities

4.6.1 A domestic bank, on grant of license, shall not exercise power to undertake authorised banking business until it has completed its incorporation in accordance with and has been authorised to begin its business under the Commercial Companies Law. Within 360 days of the above or within 360 days of the date on which a domestic bank has been listed in the commercial register as a Joint Stock Company, whichever date is later, the bank must have fully complied with all applicable requirements and conditions to the commencement of operations as required by this Title, the Commercial Companies Law and any other applicable laws.

4.6.2 The failure by the bank to commence operations within the above period shall result in an automatic revocation of the authorization unless the Central Bank has authorized an extension of such period based upon justifiable submissions by the applicant.
4.6.3 The failure of any bank to commence operations at the authorised branch within 180 days from the date of approval shall result in automatic revocation of the license unless the Central Bank grants an extension of period based upon justifiable submissions by the Licensee.

4.7 Application for Reconsideration

4.7.1 Any person adversely affected by the decision of the Central Bank not to grant a bank license may request the Central Bank within a reasonable time to reconsider such decision.  

4.8 Reorganization

4.8.1 No domestic bank, licensed hereunder, shall amend its constitutive contract or Articles of Incorporation or effect any change in its organization or operation in a manner which would have required such Licensee to furnish different information in its application for a banking license submitted to the Board of Governors in accordance with applicable provisions without obtaining the prior approval of the Board of Governors to such amendment or change.

4.9 Launching New Islamic Banking Products

4.9.1 Licensees shall apprise, beforehand, the Central Bank of launching new Islamic banking products highlighting the following:

4.9.1.1 The product structure, features and associated risks;

4.9.1.2 Basis for their conformity with Shari’a requirements and the requirements of the Banking Law;

4.9.1.3 Accounting, reporting, prudential and all regulatory treatment proposed;

4.9.1.4 Confirmation of clearance by the respective SSB and its cautionary observations, if any, and

4.9.1.5 Any other information as required by the Central Bank.
5. Investment Banking Activities

5.1 Introduction

5.1.1 Investment banking activities may consist of one or more of the following tiers of activities: Corporate finance, project finance, investment brokerage and investment advisory services, investment management, underwriting of securities and custodian and fiduciary services.⁴¹

5.1.2 All investment banking business undertaken by the Licensees shall be Shari’a compliant in all respects and appropriate approvals from the respective SSBs shall be obtained.

5.2 Types of Investment Banking Activities

5.2.1 Corporate Finance: The financial advisory services relating to the public raising of capital on Muscat Securities Market (“MSM”), financing, mergers and acquisitions of or by publicly quoted companies. Preparation of prospectuses relating to such activities is also considered as a corporate finance activity.

5.2.2 Project Finance: Project finance involves the preparation of detailed plans, analysis and forecasts for the financing of projects. It also involves attempting to raise capital on the basis of the forecasts through limited circulation of the prospectus to unconnected third parties.

5.2.3 Investment Brokerage and Investment Advisory Services: This involves the offer of brokerage services, in or from the Sultanate for the purchase and sale of securities on an agency basis and the offer of investment advisory service to investors for securities quoted in MSM or / and securities approved by the Central Bank.

5.2.4 Investment Management (discretionary): The provision of a fully discretionary investment management service subject to a discretionary management agreement for securities quoted in MSM or / and securities approved by the Central Bank.

5.2.5 Underwriting of Securities - Lead Underwriting: Contracting with an issuer of equity or debt finance and guaranteeing the part or total placement of the issue whether private or public for a fee.

5.2.6 Sub-Underwriting: Contracting with a lead underwriter and guaranteeing the part placement of an issue whether private or public equity or debt finance for a fee.
5.2.7 **Custodian and Fiduciary Services:** The acceptance and administration of securities in safekeeping and the exercise of trustee functions for third parties.

5.2.8 **Other Services:** Any other activities which may be defined by the Central Bank as investment banking and when approved.

5.3 **Application for a License**

5.3.1 Any Licensee operating in Oman that wishes to engage in investment banking activities in the Sultanate must obtain a license for investment banking from the Central Bank unless otherwise specifically exempted.

5.3.2 Application for a license to conduct investment banking activities shall be submitted to the Central Bank in the prescribed form along with the other required documents. The scope of the license may be comprehensive of all investment banking activities or restricted to certain specific area(s) to be defined in the license.

5.3.3 The Licensee shall display the license obtained at a prominent place in its office and shall disclose to all its clients or any other person on a need to know basis all the investment activities that it is permitted to conduct along with relevant terms.

5.3.4 Licensee’s application for investment banking shall require everything that is applicable to conventional investment banking license in addition to the following requirements:

5.3.4.1 Appointment of a Shari’a Supervisory Board;

5.3.4.2 Appointment of an Internal Shari’a Reviewer with compliance and audit set ups; and

5.3.4.3 Demonstration of Shari’a compliance capabilities in all respects.

5.4 **Application and License Fees**

5.4.1 The application shall be accompanied by a non-refundable fee of RO 500 for each tier applied for with a maximum of RO 2,000.

5.4.2 An annual license fee of RO 500 for each tier and a maximum of RO 2,000 shall be payable upon issuance of the license.

5.5 **Issuance of the License**

5.5.1 An Investment banking license shall be issued by the Central Bank when the following conditions are met:
5.5.1.1 The activities applied for shall not be in conflict with the public interest, shall be beneficial and necessary to the economic growth and development of the Sultanate and there is a justified need in the market for the service;

5.5.1.2 The applicant shall demonstrate technical, management and administrative capability of undertaking the type of investment banking activities requested and shall provide reasonable assurance that these activities will be conducted with professional competence and financial prudence.

5.5.2 It is a requirement that the above conditions are met at all times in order to hold the license.

5.6 Protection of Investors

5.6.1 In carrying out the investment activities, the Licensee shall have a primary responsibility towards the investors. Therefore, the Licensee shall have to ensure the following:

5.6.1.1 Act with care, prudence and due diligence in undertaking all investment activities;

5.6.1.2 Disclose all material and relevant information in good faith, with the objective of ensuring fair dealing and transparency;

5.6.1.3 Ensure that investors are advised of the nature and extent of the risk that they will undertake in any proposed investment;

5.6.1.4 Clearly define the precise nature of the contractual relationships between the Licensee and its investors and identify clearly, along with all other terms, charges that will be collected for the services offered;

5.6.1.5 Where discretionary authority is given by the investor to the Licensee both parties shall sign an agreement, prior to any investment activity, which outlines the terms of the discretionary authority granted;

5.6.1.6 Not to enter into any transactions which will create an actual or potential conflict of interest between its own investors on one side and the Licensee or any related party on the other side unless appropriate disclosures are made and necessary diligence is observed;

5.6.1.7 To clearly separate, at all times, the assets of the investors from the assets of the Licensee;

5.6.1.8 The Licensee shall at all times maintain an adequate level of fiduciary and professional indemnity (Takaful) as determined by the Central Bank;

5.6.1.9 Ensure transparency and not publish any misleading information; and

5.6.1.10 Any other relevant instructions issued by the Central Bank.
5.7 Capital / Net Worth

5.7.1 The Central Bank may advise the Licensees that wish to undertake investment banking activities to increase their capital / net worth prior to the commencement of such activities.

5.8 Ratios

5.8.1 The Central Bank is authorized to issue appropriate procedures to the Licensees determining the ratios to be maintained in the below mentioned categories:

5.8.1.1 Capital and reserves (net worth) ratio to the total or partial liabilities whether these liabilities are on- or off- balance sheet;

5.8.1.2 Capital and reserves (net worth) ratio to the total assets or share of the assets whether these are on- or off- balance sheet;

5.8.1.3 Liquid assets ratio to total liabilities whether these are on- or off- balance sheet; and

5.8.1.4 The Central Bank shall set limits on the maximum underwriting that can be accepted for the Licensees to undertake underwriting activities.

5.8.2 The maximum underwriting limit shall be related to the net worth of the Licensees.

5.8.3 Underwriting powers are restricted to 20% of net worth (or such other percentage as the Central Bank stipulates from time to time). 29

5.8.4 Investment banking business of underwriting and launching of Islamic Collective Investment Schemes shall be subject to prior approval of the Central Bank.

5.9 Prohibited Activities

5.9.1 A Licensee shall not be allowed to enter into obligations which may engage its financial liabilities, such as underwriting of securities, indemnities and other commitments relevant to these, in excess of the limit(s) specified by the Central Bank.

5.9.2 A Licensee shall not purchase securities which it intends to hold for its own account or sell securities which it already holds for its own account, to an investor unless it discloses the fact that it is acting as principal. In all such transactions, the Licensee shall make sure that the price and other aspects of the transaction are in line with the price and other aspects for the same transaction if it were done on a third party basis.
5.9.3 A Licensee shall not undertake any activities which are Shari’a non-compliant or cast doubt on Shari’a compliance of the Licensee.

5.9.4 A Licensee shall not undertake any activities which are not prudent or are specifically prohibited by the Central Bank.

5.10 Central Bank’s Regulatory and Supervisory Powers

5.10.1 The Central Bank may issue from time to time such regulations, instructions or guidance as it deems necessary for the adequate discharge of investment banking activities by the Licensees for the proper alignment and maintenance of adequate capital without decline or risk. The Central Bank may determine adequate procedures to ensure the balance between these activities and the Central Bank’s monetary and credit policies.

5.11 Approval of Capital Market Authority

5.11.1 All Licensees authorised by the Central Bank to engage in any investment banking activities and desirous of engaging in any activities, should, if so stipulated, obtain the approval of the Capital Market Authority (CMA) prior to undertaking such activities and comply with set requirements.

5.10.2 Banks have to follow the Central Bank’s requirements if they are bank-specific or more restrictive.

5.10.3 Islamic Collective Investment Schemes (ICIS), generally structured under Mudaraba or Wakala, shall be a capital market instrument and be subjected primarily to CMA’s rules and regulations.

5.10.4 In view of the Shari’a compliance requirements involved, Licensees should observe more than normally required diligence all through, covering among others, appropriate governance / management structure, policies and procedures, control and oversight, management of fiduciary duties and of conflicts of interests and transparency in disclosure of information (this needs to be timely, adequate and appropriate), avoiding misleading information and fraudulent approaches and practices by all those connected.

5.10.5 *Licensees should evolve a Shari’a compliant code of conduct for themselves and all others connected, duly cognizant of the interests of all stakeholders.*
6. **Bank Branches’ Licensing Policy and Procedures**

6.1 **Licensing Policy**

6.1.1 Licensees shall base their applications on economic and social aspects and keep up healthy growth and competition without undue overcrowding.

6.1.2 The Central Bank shall consider the following in the applications for branches:

   6.1.2.1 The economic needs of the community to be served;
   
   6.1.2.2 The availability of the banking, managerial and economic resources to accommodate branch expansion;
   
   6.1.2.3 The viability of opening new branches in the light of the number of branches in the area and markets targeted (overall economic efficiency and discharging social responsibilities may be the objective, not necessarily financial viability);
   
   6.1.2.4 The extent for reasonable achievement of projections and objectives, resource mobilization and asset build-up;
   
   6.1.2.5 The Licensee’s overall performance, performance of existing branches, efficiency, control, risk management and compliance aspects and the examination and other ratings the Licensee has attracted;
   
   6.1.2.6 Islamic banking requirements and the applicant’s compliance reach and track record will receive special attention.

6.1.3 *The Central Bank expects the Licensees to have in perspective the social responsibility and national need to promote banking habits and respond to the genuine aspirations of various locations, particularly when the need is well articulated by accredited representatives. Licensees are expected to make liberal use of data and information availed from the Government and other sources.*

6.2 **Relocation of Branches**

6.2.1 Licensees shall not make any relocation without obtaining authorization from the Central Bank.

6.2.2 Licensees shall submit requests for relocation, providing justifiable reasons for the same and taking into account the overall criteria and requirements set for licensing new branches and possible inconvenience the relocation will cause to the existing customers; particularly when the relocation is going to be a different area or business zone.

6.2.3 The Central Bank, if satisfied with the submissions, shall grant initial approval for the proposal, final approval and license being given on compliance with the
requirements, as in the case of new branch (to the extent relevant) and payment of relocation fee of RO 500 (if it involves movement to a different commercial area or location and requires surrender and re-issue of license).

6.2.4 Licensees shall ensure that inconvenience, if any, to customers is kept at a minimum on relocation and that all concerned (including the customers) are duly informed well in time.

6.3 Closure of Branches

6.3.1 There shall be no closure or making over a branch to any other Licensee without the prior approval of the Central Bank and for valid reasons.

6.3.2 Past history of closure of branches may weigh on consideration of future applications for new branches. Closure fee payable is RO 500.

6.4 Operational Requirements

6.4.1 Licensees shall ensure diligence in the running of the branches on an on-going basis. There shall be regular review of the needed infrastructure, including continuity in management and communications, security and risk management systems, practices and procedures including formulation and adherence of manual of procedures, periodic audit, control in delegation and exercising of powers, rotation of key persons and job responsibilities.

6.4.2 Licensees shall ensure that all applicable provisions of the laws including registration of the branches under the Commercial Registration Law and approvals of local governmental authorities are complied with.

6.4.3 Whenever any branch fails to meet the financial forecast or incurs loss, the Licensees shall arrange to provide their comments and proposed actions along with the submission of half yearly branch performance reports.

6.4.4 Licensees shall ensure proper maintenance and submission of accurate particulars when providing the list of operating branches and making payment of annual license fees before 31 January of every year.

6.5 Opening of Branches / Representative Offices Aboard

6.5.1 Approval of bank branches abroad shall be considered in the context of prevalent licensing policy and circumstances.

6.5.2 The application shall be taken up for consideration only when the following conditions are met:
6.5.2.1 The Licensee is financially strong and has adequate resources to finance the opening of the branches abroad. It should have satisfactory record of compliance with the capital adequacy norms stipulated by the Central Bank, at least for the immediately preceding three years;

6.5.2.2 The management of the Licensee is competent, administratively sound and has adequate experience and qualifications in the area of international banking. The management should have the ability to administer the branches abroad;

6.5.2.3 The Licensee shall have good track record of earnings and profitability, especially in the immediately preceding three years and with specific reference to Islamic banking in all its aspects of governance, compliance, control and operations.

6.5.2.4 The Licensee’s ratio of financing in arrears for more than 90 days to total financing at the end of the last completed calendar month shall not exceed the industry average ratio or 8%, whichever is lower. The level of financing loss provisions and the trend of non-performing financing shall be taken into account;

6.5.2.5 The internal control systems of the Licensee should not have attracted adverse criticism during the latest Central Bank examination. The Licensee’s branches abroad shall have well established modern telecommunication and computer network with the head office in Oman. Should the Licensee have more than one branch abroad in the same country, all the branches shall be online with the principal branch in that country and the principal branch will be directly online with the head office in Oman;

6.5.2.6 The ratings assigned to the Licensee by the Central Bank, external auditors and rating agencies or any other professional agencies shall be taken into account;

6.5.2.7 At least 60% of the voting stock of the Licensee shall be owned by Omani nationals;

6.5.2.8 At least two third of the members of the board of directors of the Licensee shall be Omani nationals;

6.5.2.9 The Licensee’s investments in premises, furniture, equipment and fixtures shall not exceed 50% of its net worth;

6.5.2.10 The host country shall have well drawn out legal framework. Its rules and regulations should bring out with clarity the position in regard to repatriation of profit annually and permit the transfer of assets after the closure of the branches to their head office in Oman; and

6.5.2.11 The host country should not be pursuing any discriminatory policies against the Sultanate.
6.5.3 The Licensee’s branches abroad are required to submit to the Central Bank, through their head office in Oman, reports and returns in the prescribed format according to the modalities and the periodicity as would be determined by the Central Bank.

6.5.4 All branches abroad of domestic Licensees are required to forward to the Central Bank through their head office, authenticated photocopies of the examination / internal audit / statutory audit / host supervisor’s examination or any other special report recorded on their working, as soon as it is received by them.

6.5.5 The Licensee shall designate and appoint an officer in the head office who should be charged with the responsibility for the branches abroad for following up the coverage on the overall economy of the host country including the status of banking and especially the coverage concerning the branch abroad in the media i.e. leading local language and English language newspapers, journals and the reporting in the other media and compile a weekly report on such coverage to the top management of the Licensee. A copy of the said report shall be simultaneously forwarded to the Central Bank.

6.5.6 The Licensee shall post at least one of its suitable Omani employees from the head office by rotation to gain work experience at its branch abroad.

6.5.7 The Licensee shall bring in fresh capital for its branch abroad and such capital shall not be counted as a part of the Licensee’s net worth for its Oman operations.

6.6 Other Outlets

6.6.1 Licensees shall get familiarised on an on-going basis with approval and other requirements on all other business or non business outlets like ATMs and on-site banking facilities and ensure compliance at all times.
7. **Relevant Fees**

7.1 **Application and License Fees**

7.1.1 List of application / license fees payable is given in Attachment 9.2.

7.2 **Payment of Annual License Fees**

7.2.1 All Licensees shall pay the annual license fees on or before 31 January of each calendar year.

7.2.2 The payment shall be accompanied by the lists of branches in Oman and abroad, ATMs & Kiosk Banking Machines at branch premises, off-site ATMs and Kiosk Banking Machines, Cash Deposit Machines and on-site Banking Facilities / units (including Mobile Banking Units and spin off units like Departments of Head Office and branches, whether fees are payable on them or not).

7.2.3 Licensees shall arrange to pay (separately) fees for their licensed investment banking activities as stipulated.

7.2.4 Licensees should ensure accuracy of the payment and lists without fail.
8. Dissolution, Liquidation and Termination of Business

8.1 Voluntary Dissolution and Liquidation

8.1.1 A Licensee may enter into voluntary liquidation, dissolution or termination of its banking business in the Sultanate by submitting a request to the Central Bank in such manner and in such form as prescribed by the Central Bank.\textsuperscript{31}

8.1.2 The Board of Governors may, in its discretion, upon review of a request by a Licensee for voluntary dissolution, liquidation or termination of its banking business in the Sultanate, approve the request, prescribe such conditions as the Board of Governors may deem necessary for the orderly termination of such business or deny the request for voluntary liquidation, termination or dissolution and apply the provisions of Article 83 of the Banking Law.

8.1.3 The Board of Governors shall have the right to revoke its approval of a request for voluntary dissolution, liquidation or termination of the banking business in the Sultanate and to apply the provisions of Article 83 of the Banking Law if during the course of such dissolution, liquidation or termination any conditions prescribed hereunder are violated, the assets of the Licensee are improperly applied or if there is evidence of other improper conduct.

8.1.4 The Board of Governors shall have the right to designate or otherwise approve any person who is to act as the liquidator of the Licensee to the extent that such liquidation is of banking business and operations in the Sultanate and to the degree that such designation or approval is necessary to assure compliance with the Banking Law and to represent the interests of all depositors of such Licensee.

8.2 Involuntary Dissolution and Liquidation

8.2.1 The Board of Governors may take possession of the business and property of any domestic Licensee and the business and property within the Sultanate of any foreign Licensee, suspend the license of any Licensee and administer the business and property of such Licensee during any period of suspension, suspend the operations of any Licensee for a specified period, or liquidate or terminate the business of any Licensee and authorize the reopening, or require a reorganization before a subsequent reopening, or order at any time the sale in whole or in part of the business, property, assets and / or liabilities of such Licensee whenever it shall appear that any such Licensee:\textsuperscript{32}
8.2.1.1 Has actually failed or the circumstances indicate that it will fail to comply with the orders, directives or policies of the board of governors;

8.2.1.2 Has actually violated or the circumstances indicate that it will violate any provisions of the Banking Law, regulations of the Central Bank or any other laws of the Sultanate;

8.2.1.3 Has accepted or may accept deposits at a time when the Licensee is in an unsafe or insolvent condition or it appears that the Licensee is or may be unable to pay valid claims fully as they become due;

8.2.1.4 Is conducting its business or the business of any authorized branch in an unauthorized, unsafe manner or is in an unsound, unsafe condition to transact or continue to transact banking business;

8.2.1.5 Has an impairment of its capital;

8.2.1.6 Has suspended or is in danger of suspending the payment of any of its obligations;

8.2.1.7 Has not been carrying on banking business; or

8.2.1.8 Has violated Shari’a rules and principles.

8.2.2 The Board of Governors shall notify all officers, directors and shareholders of any action taken by the Central Bank under Article 83 of the Banking Law and shall cause a notice to all shareholders of any liquidation hereunder to be published in the Official Gazette in the same manner as notice to depositors and claimants pursuant to Article 84 of the Banking Law.

8.2.3 The Board of Governors shall appoint an administrator for any Licensee whose operations have been suspended or otherwise affected by the actions of the Board of Governors under Article 83.

8.3 Notice to Depositors and Claimants

8.3.1 In a proceeding for the liquidation of a Licensee instituted by the Board of Governors under this Chapter, the administrator shall set an expiration date for the presentation of all claims and proofs thereof. He shall give notice to all persons shown in the records of the Licensee in liquidation as having claims against such Licensee not less than 60 days prior to such expiration date. In addition, the administrator shall cause a notice to all depositors / Investment Account Holders and persons who may have claims against the Licensee in liquidation to be published in each issue of the Official Gazette for a period of at least two consecutive months immediately preceding the expiration date.33
9. Attachments

9.1 Essentials of Islamic Modes of Financing

9.1.1 The next few pages provide an overview of the most commonly used Islamic contracts or modes of financing. These include:

9.1.1.1 Murabaha
9.1.1.2 Musawama
9.1.1.3 Mudaraba
9.1.1.4 Musharaka
9.1.1.5 Diminishing Musharaka
9.1.1.6 Salam
9.1.1.7 Istisn'a
9.1.1.8 Ijarah
9.1.1.9 Sukuk

9.1.2 Murabaha

9.1.2.1 Murabaha means a sale of goods by a person to another under an arrangement whereby the seller (Licensee) is obliged to disclose to the buyer (customer) the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold.

9.1.2.2 Murabaha may be transacted in both tangible and intangible assets. Murabaha shall not be transacted in respect of any debt instrument including receivables.

9.1.2.3 Being a sale transaction, it is essential that the commodities which are the subject of sale in a Murabaha transaction, must be existing, owned by the seller and in his physical or constructive possession. Therefore, it is necessary that the seller must have assumed the risks of ownership before selling the commodities to the buyer.

9.1.2.4 Murabaha, like any other sale, requires an offer and acceptance which will include certainty of price, place of delivery, and date on which the price, if deferred, will be paid.

9.1.2.5 In a Murabaha transaction, the appointment of an agent, if any, the purchase of goods by or for and on behalf of the Licensee and the ultimate sale of such goods to the customer shall all be transactions independent of each other and shall be so separately documented.
9.1.2.6 The invoice issued by the supplier will be in the name of the Licensee as the commodity would be purchased by an agent on behalf of the Licensee.

9.1.2.7 Once the sale transaction has been concluded, the selling price determined cannot be changed.

9.1.2.8 It can be stipulated while entering into the agreement that in case of late payment or default by the buyer, he shall and be deemed to have irrevocably authorized the Licensee to recover from him an amount calculated at a predetermined percentage per day or per annum as compulsory contribution to charity fund constituted by the Licensee. This contribution to charity fund shall not constitute income of the Licensee.

9.1.2.9 The buyer may be required to furnish security in the form of pledge, hypothecation, lien, mortgage or any other form of encumbrance on asset. However, the mortgagee or the charge-holder shall not derive any financial benefit from such security.

9.1.2.10 If the buyer pays any security deposit in cash to the Licensee, the same shall be placed in a profit and loss account under lien of the Licensee. The buyer shall be entitled to receive the profit from such Profit and Loss Sharing (“PLS”) account against the security deposit. However, in case of default by the buyer, the Licensee is allowed to adjust the security deposit to the extent of buyer’s liability.

9.1.2.11 A Murabaha contract cannot be rolled over because the goods once sold by the Licensee become property of the customer and, hence, cannot be resold to the same (or another) financial institution for the purpose of obtaining further credit. The Licensee can, however, extend the repayment date provided that such extension is not conditional upon an increase in the selling price of goods, originally agreed.

9.1.2.12 Buy-back arrangement is prohibited. The commodities already owned by the customer cannot become the subject of a Murabaha transaction between him and any Licensee. All Murabaha transactions must be based on the purchase of goods from third party(ies) by the Licensee for sale to the customer.

9.1.3 Musawama

9.1.3.1 Musawama is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former.

9.1.3.2 Musawama is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawama is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawama as well.
9.1.3.3 Musawama can be used where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

9.1.4 Mudaraba

9.1.4.1 Mudaraba means an arrangement in which a person participates with his money (called Rabb ul Maal) and another with his efforts (called Mudarib) for sharing in profit from investment of these funds in an agreed manner.

9.1.4.2 A Mudarib may be a natural person, a group of persons, or a legal entity and a corporate body.

9.1.4.3 Rabb ul Maal shall provide his investment in money or species, other than receivables, at a mutually agreed valuation which shall be placed under the absolute disposal of the Mudarib.

9.1.4.4 The conduct of business of Mudaraba shall be carried out exclusively by the Mudarib within the framework of mandate given in the Mudaraba agreement.

9.1.4.5 The profit shall be divided in strict proportion agreed at the time of contract and no party shall be entitled to a predetermined amount of return or remuneration.

9.1.4.6 Financial losses of the Mudaraba shall be borne solely by the Rabb ul Maal, unless it is proved that the Mudarib has been guilty of fraud, negligence or willful misconduct or has acted in contravention of the mandate.

9.1.4.7 The liability of Rabb ul Maal is limited to his investment unless otherwise specified in the Mudaraba contract.

9.1.5 Musharaka

9.1.5.1 Musharaka means relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.

9.1.5.2 Investments come from all partners / shareholders hereinafter referred to as partners.

9.1.5.3 Profits shall be distributed in the proportion mutually agreed in the contract.

9.1.5.4 If one or more partners choose to become non-working or silent partners, the ratio of their profit cannot exceed the ratio which their capital investment bears to the total capital investment in Musharaka.

9.1.5.5 If Mudarib in a Shirkah arrangement also contributes his own capital to the business, he will be entitled to share the profit in proportion to his own capital in addition to his share as Mudarib according to the agreed proportion.

9.1.5.6 It is not allowed to fix a lump sum amount for any of the partners, or any rate of profit tied up with his capital. A management fee however, can be paid to the
partner managing the Musharaka provided the agreement for the payment of such fee is independent of the Musharaka agreement.

9.1.5.7 Losses are shared by all partners in proportion to their capital.

9.1.5.8 All assets of Musharaka are jointly owned in proportion to the capital of each partner.

9.1.5.9 All partners must contribute their capital in terms of cash or kind at an agreed valuation as determined at the time of entering into Musharaka.

9.1.5.10 On the culmination or termination of Musharaka, the amount of Musharaka investment standing to the credit of Licensee shall be undertaken by the client of the Licensee to be discharged and such investment shall be determined on the basis of valuation as agreed between the parties at the time of commencement of Musharaka.

9.1.5.11 It can be stipulated while entering into the agreement of Musharaka that in case of any delay or default in the payment of profit by the Musharik (the client of Licensee), he shall and be deemed to have irrevocably authorized the Licensee to recover from him an amount calculated at a predetermined percentage per day or per annum as compulsory contribution to charity fund constituted by the Licensee, which shall not constitute its income.

9.1.5.12 The delay or default shall be deemed to have taken place when the payment of profit or repayment of investment payable at an agreed date has been wilfully delayed.

9.1.6 Diminishing Musharaka

9.1.6.1 Diminishing Musharaka (DM) is a form of co-ownership in which two or more persons share the ownership of a tangible asset in an agreed proportion and one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner.

9.1.6.2 DM can be created only in tangible assets. DM will be limited to the specified asset(s) and not to the whole enterprise or business.

9.1.6.3 A DM arrangement would consist of following three steps, i.e.

9.1.6.4 Creation of joint ownership between the co-owners;

9.1.6.5 Renting out by one co-owner the undivided share in the asset owned to the other co-owner; and

9.1.6.6 Selling in periodic installments by one co-owner his share to the other co-owner(s).
9.1.6.7 All other terms and conditions as are essential to co-ownership, Ijarah and sale shall be fulfilled in respect of different stages in the process of DM arrangement.

9.1.6.8 Proportionate share of each co-owner must be known and defined in terms of investment.

9.1.6.9 Expenses incidental to ownership may be borne jointly by the co-owners in the proportion of their co-ownership.

9.1.6.10 Loss, if any, shall be borne by the co-owners in the proportion of their respective investments.

9.1.6.11 The amount of periodic payment would go on decreasing with purchase of ownership units by the purchasing co-owner.

9.1.6.12 Each periodic payment shall constitute a separate transaction of Sale.

9.1.6.13 A separate agreements / contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other in order to ensure that each agreement is a separate transaction.

9.1.6.14 The sequencing of the agreements in a DM shall be as follows:

9.1.6.15 There shall be an agreement of co-ownership between the parties.

9.1.6.16 There shall be an agreement of lease between the co owners to lease out one’s share in such property to another for an agreed periodic payment in consideration of the use of the former’s share by the latter.

9.1.6.17 The sale of units by one co-owner to the other co-owner as aforesaid shall be documented in such a manner as the parties may mutually agree.

9.1.7 **Salam**

9.1.7.1 Salam is a kind of sale whereby the seller undertakes to supply specific goods to a buyer (Licensee) at a future date in consideration of a price fully paid in advance at the time the contract of sale is made.

9.1.7.2 The buyer shall pay the price in full to the seller at the time of effecting the sale. Otherwise, it will be tantamount to a sale of debt against debt, which is expressly prohibited in Shari’a.

9.1.7.3 The specifications, quality and quantity of the commodity must be determined to avoid any ambiguity which could become a cause of dispute.

9.1.7.4 Date and place of delivery must be agreed upon but can be changed with mutual consent of the parties.

9.1.7.5 In a Salam transaction, the buyer cannot contractually bind the seller to buy-back the commodity that will be delivered by the seller to the buyer.
9.1.7.6 In Salam transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any person.

9.1.7.7 The Licensee can enter into a Parallel Salam contract without any condition or linkage with the original Salam contract. In one of them, the Licensee will be the buyer and in the second the seller. Each one of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of original contract are dependant on the rights and obligations of the parallel contract. Further, Parallel Salam is allowed with a third party only.

9.1.7.8 In order to ensure that the seller shall deliver the commodity on the agreed date, the Licensee can ask him to furnish a security.

9.1.7.9 In case of multiple commodities, the quantity and period of delivery for each of them should be separately fixed.

9.1.7.10 It can be stipulated while entering into the agreement that in case of delay in delivery of the commodity by the seller, he shall and be deemed to have irrevocably authorized the Licensee to recover from him an amount calculated at a predetermined percentage per day or per annum as compulsory contribution to charity fund constituted by the Licensee. This contribution to charity fund shall not constitute income of the Licensee. The Licensees can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.

9.1.8 Istisna’a

9.1.8.1 Istisna’a is a kind of sale whereby the buyer places an order to manufacture, assemble or construct, or cause so to do anything to be delivered at a future date.

9.1.8.2 The commodity must be known and specified to the extent of removing any ambiguity regarding its specifications including kind, type, quality and quantity etc.

9.1.8.3 Price of the goods to be manufactured must be fixed in absolute and unambiguous terms. The agreed price may be paid in lump sum or in installments in the matter mutually agreed by the parties.

9.1.8.4 Providing of material required for manufacture of commodity is not the responsibility of the buyer. Unless otherwise mutually agreed, any party may cancel the contract unilaterally if the seller has not incurred any direct or indirect cost in relation thereto.

9.1.8.5 If goods manufactured conform to the specifications agreed between the parties, the orderer (purchaser) cannot decline to accept them except if there is an obvious defect in such goods. However, the agreement can stipulate that if the
delivery is not made within the mutually agreed time period, then the buyer can refuse to accept the goods.

9.1.8.6 The Licensee (buyer in Istisna’a) can enter into a Parallel Istisna’a contract without any condition or linkage with the original Istisna’a contract. In one of them, the Licensee will be the buyer and in the second the seller. Each of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependent on the rights and obligations of the parallel contract. Further, Parallel Istisna’a is allowed with a third party only.

9.1.8.7 In Istisna’a transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any other person.

9.1.8.8 If the seller fails to deliver the goods within the stipulated period, the price of the commodity can be reduced by a specified amount per day as per the agreement.

9.1.9 Ijarah

9.1.9.1 Ijarah (Islamic leasing) is a contract whereby the owner of an asset (lessor / Licensee), other than consumables, transfers its usufruct to another person (lessee) for an agreed period for an agreed consideration.

9.1.9.2 In Ijarah / leasing, the leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Anything which cannot be used without consuming the same cannot be leased out like money, edibles, fuel, etc.

9.1.9.3 Until such time that assets to be leased are delivered to the lessee, lease rentals shall not become due and payable.

9.1.9.4 During the entire term of the lease, the lessor must retain title to the assets, and bear all risks and rewards pertaining to ownership. However, if any damage or loss is caused to the leased assets due to the fault or negligence of the lessee, the consequences thereof shall be borne by the lessee. The consequences arising from non-customary use of the asset without mutual agreement will also be borne by the lessee. The lessee is also responsible for all risks and consequences in relation to third party liability, arising from or incidental to operation or use of the leased assets.

9.1.9.5 The insurance of the leased asset should be in the name of lessor and the cost of such insurance shall be borne by him. However the lessee may be allowed to arrange insurance on account of the lessor as the insured and the premium so paid by the lessee shall be reimbursed by the lessor. Licensees should prefer takaful, wherever feasible, for insurance of assets. However, in the
circumstances where takaful is not considered feasible by the Licensee, the reasons thereof shall be recorded in writing by the Licensee.

9.1.9.6 A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties. It shall be required to record the reasons thereof in writing.

9.1.9.7 Either party can make a unilateral promise to buy / sell the assets upon expiry of the term of lease, or earlier at a price and at such terms and conditions as are agreed, provided that the lease agreement shall not be conditional upon such sale. Alternatively, the lessor may make a promise to gift the asset to the lessee upon termination of the lease, provided the lessee has fulfilled all his obligations. However, there shall not be any stipulation in the lease agreement purporting to transfer of ownership of the leased assets at a future date.

9.1.9.8 The amount of rental must be agreed in advance in an unambiguous manner either for the full term of the lease or for a specific period in absolute terms.

9.1.9.9 Contract of lease will be considered terminated if the leased asset ceases to give the service for which it was rented. However, if the leased asset is damaged during the period of the contract but is capable of being repaired, the contract will remain valid.

9.1.9.10 It can be stipulated while entering into the agreement that in case of late payment of rentals by the lessee, he shall and be deemed to have irrevocably authorized the Licensee to recover from him an amount calculated at a predetermined percentage per day or per annum as compulsory contribution to charity fund constituted by the Licensee. This contribution to charity fund shall not constitute income of the Licensee. The Licensees can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.
9.1.10 Sukuk Structures

9.1.10.1 Murabaha Sukuk

9.1.10.1.1 Murabaha Sukuk are based on the Islamic contract of Murabaha. The word ‘Murabaha’ is based on the Arabic term ‘Ribh’, which literally means profit.

9.1.10.1.2 Murabaha Sukuk are certificates of equal value issued for the purpose of financing the purchase of goods through Murabaha, in which certificate holders are granted ownership of the Murabaha commodity. The transaction comprises of the originator (as seller), investors (as buyers) and a Special Purpose Vehicle (“SPV”).

9.1.10.2 Mudaraba Sukuk

9.1.10.2.1 Mudaraba Sukuk are based on the Islamic contract of Mudaraba. The contract is a form of equity based relationship between parties whereby one party provides the capital and the other party supplies the business with management and entrepreneurship skills.

9.1.10.2.2 The party contributing capital cannot participate in the management of the business in Mudaraba. The capital provider is referred to as ‘Rabb ul Maal’ and the party contributing management and expertise is referred to as ‘Mudarib’. Hence, Mudaraba Sukuk are certificates of equal value representing ownership in projects or activities managed on the basis of Mudaraba.

9.1.10.3 Musharaka Sukuk

9.1.10.3.1 Musharaka Sukuk are based on the Islamic contract of Musharaka. The word Musharaka is based on the term ‘Shirkah’, which refers to parties combining capital contributions for a specific business venture.

9.1.10.3.2 Musharaka Sukuk are certificates of equal value representing ownership of asset or project managed on the basis of Musharaka. The aim of Musharaka Sukuk is to utilize the ability to mobilize funds for establishing new projects, developing existing ones or financing business activities on the basis of a partnership.

9.1.10.4 Salam Sukuk

9.1.10.4.1 Salam contract is one of the unique contracts in Islamic finance as it is an exception of two rules; (i) the assets involved in Shari’a compliant transactions must exist, be owned by and in the possession of the seller, and (ii) the impermissibility of forward sale contracts.

9.1.10.4.2 Salam Sukuk are certificates of equal value issued for the purpose of mobilizing capital so that the ownership of the goods to be delivered on the basis of Salam is transferred to the Sukuk holders. The process comprises of the originator (as seller), investors (as buyers) and a SPV.
9.1.10.4.3 Salam Sukuk can be used as instruments to manage liquidity or for institutions seeking short term liquidity requirements.

9.1.10.5 Istisna’a Sukuk

9.1.10.5.1 Similar to Al Salam, the Istisna’a contract is another sale transaction in which the price and the delivery of the assets occur at different dates. It is a contract whereby assets are sold by one party with an obligation to deliver the assets at a future date.

9.1.10.5.2 Istisna’a Sukuk are certificates of equal value that represent ownership in a manufactured asset. Istisna’a Sukuk can be used in project finance as they are a facility to mobilize funds to construct assets. The profits gained after constructing/manufacturing the assets are to be used to repay the capital that was seeded for the Sukuk (or project). Istisna’a Sukuk issuers are allowed to enter into a parallel Istisna’a agreement, whereby the task of manufacturing the assets is subcontracted to a third party.

9.1.10.6 Ijarah Sukuk

9.1.10.6.1 Ijarah Sukuk are based on the Islamic contract of Ijarah. The term Ijarah implies ‘leasing’ or hiring of a physical asset; in which the lessor leases an already owned asset to the lessee for a predetermined period of time and consideration.

9.1.10.6.2 Ijarah Sukuk are certificates of equal value that represent ownership in an asset or certificates of equal value that represent ownership of the usufruct of an asset. As such, Ijarah Sukuk can be either asset backed or service backed securities. The assets underlying an Ijarah Sukuk transaction should have value in use and can be property (piece of land) or equipment such as vehicles, aircrafts and ships, etc.
### 9.2 Details of Application and License Fees to be Paid by Banks

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<thead>
<tr>
<th></th>
<th>Application Fee</th>
<th>Annual License Fee</th>
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<tbody>
<tr>
<td>A)</td>
<td>Application to conduct banking business in the Sultanate</td>
<td>RO 5,000</td>
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<tr>
<td>B)</td>
<td>Application to establish a branch office</td>
<td>RO 500</td>
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<tr>
<td>C)</td>
<td>Annual license fee- principal office</td>
<td>RO 5,000</td>
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<tr>
<td>D)</td>
<td>Annual license fee – branch office</td>
<td>RO 500</td>
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<tr>
<td>E)</td>
<td>Annual license fee- Off-Site Automated Teller Machine</td>
<td>RO 250</td>
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<tr>
<td>F)</td>
<td>Annual license fee – Off-site Cash/Cheque Deposit Machine</td>
<td>RO 125</td>
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<tr>
<td>G)</td>
<td>Onsite banking facility</td>
<td>RO 250</td>
</tr>
<tr>
<td>H)</td>
<td>a) Merger of Banks</td>
<td></td>
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<tr>
<td>1.</td>
<td>For a surviving bank whose registered name is retained; per branch or Main Office taken over during the merger process.</td>
<td>RO 500</td>
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</table>
| 2. | For a new bank adopting an entirely new business name:  
   i) Principal Office  
   ii) Each branch acquired (under the new name) | RO 5,000 | RO 5,000 |
|   | RO 500 | RO 500 |
| b) | Change of business name for re-issuance of a new license  
   i) Principal Office  
   ii) For each Branch | - | RO 5,000 |
|   | - | RO 500 |
| c) | For a bank taking over/purchasing a branch office of another bank (partially or totally), it shall apply for re-issuance of a new license for each branch acquired. | RO 500 | RO 500 |
| d) | Relocation of banking office leading to a transfer to a different commercial area or business zone  
   i) Principal Office  
   ii) For each branch | - | RO 5,000 |
<p>|   | - | RO 500 |</p>
<table>
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<tr>
<th><strong>Closing</strong></th>
<th><strong>Fee</strong></th>
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<td>Principal Office</td>
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<td>For each branch</td>
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<td><strong>RO 5,000</strong></td>
<td><strong>RO 500</strong></td>
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<tr>
<th><strong>Opening of branches / representative offices abroad</strong></th>
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<tbody>
<tr>
<td><strong>I)</strong> Non-refundable Application Fee</td>
</tr>
<tr>
<td>a) For the opening of the first branch / representative office in any country</td>
</tr>
<tr>
<td>b) For the opening of each additional branch / representative office in the same country</td>
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<tr>
<th><strong>Annual License Fee</strong></th>
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<tr>
<td>(payable during the year of initial licensing and, thereafter, on or before the 31st day of January in each year)</td>
</tr>
<tr>
<td>a) In respect of the first branch / representative office in any country</td>
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<tr>
<td>b) In respect of each additional branch / representative office in the same country</td>
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<th><strong>Investment Banking Business</strong></th>
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<tr>
<td>ROI for each tier applied for with a maximum of RO 2,000/-</td>
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1. Article 52 of the Banking Law
2. Article 50 of the Banking Law
3. Regulation BM/REG/40/96
4. Article 57 b of the Banking Law
5. Article 57 c of the Banking Law
6. BM 652
7. BM 954
9. Article 77 C of the Banking Law
10. Article 80 (b) of the Banking Law and BM 813
11. BM 868
12. Article 77 C of the Banking Law
13. Article 62 of the Banking Law, Regulation BM/REG/36/5/90 and BM 1005, 1022 and 1050
Article 63 of the Banking Law
Regulation BM/REG/008/7/75
BM 729
BM 729
Regulation BM/REG/010/11/75
Regulation BM/REG/008/7/75
BM 729
BM 729
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Article 56 of the Banking Law
BM 729, BM 731, BM 881, BM 885 and BM 991
BM 991
Article 58 of the Banking Law
Article 57 of the Banking Law
BM 720
65(c)(3)(i) of the Banking Law
BM 829
Article 82 of the Banking Law
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TITLE 2: GENERAL OBLIGATIONS AND GOVERNANCE

Islamic Banking Regulatory Framework
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1. General Obligations

1.1 Scope of Application

1.1.1 These rules and guidance will apply to full-fledged domestic Islamic Banks, Islamic Windows of conventional domestic banks and Islamic banking branches of foreign banks in the Sultanate (hereinafter referred to as “Licensees”) regulated and supervised by the Central Bank of Oman (“Central Bank”).

1.2 Internal Authorization for Islamic Banking

1.2.1 The Memorandum and Articles of Association of Licensees should provide for conduct of Islamic banking business according to Shari’a rules and principles. Appropriate approvals from the shareholders and/or the Board of Directors as necessary must be obtained.

1.3 Systems and Controls

1.3.1 Licensees have to establish and maintain systems and controls which ensure Shari’a compliance of their operations and business activities, in addition to the normal compliance requirements.

1.4 Conduct of Business

1.4.1 Licensees shall conduct their business in accordance with Shari’a principles and in line with contemporary professional standards.

1.4.2 Islamic banking is faith based. Licensees are obliged to have appropriate conduct of business based upon strong ethical principles, practices and conviction. There are many stakeholders, besides the shareholders, and including investment account holders, looking for and sensitive to Shari’a compliance. Islamic banking is collaborative banking; financial inclusion, fairness and risk sharing are some important hallmarks. It is not profit sharing per se but profit sharing with values and where principle comes before profit.

1.4.3 Islamic banking has larger scope for fiduciary transactions; prudence on the one hand as a banker in the ordinary course of business and larger diligence including transparency and disclosure on the other hand are called for correspondingly.

1.4.4 The underlying principles / pre-requisites in conduct of business should include truthfulness, honesty and fairness, due care and diligence, system and staff capabilities,
understanding of the clients, proper disclosure to clients and addressing conflicts of interests.

1.4.5 Diligent adherence should cover associated aspects like public policy and objectives, not attempting regulatory arbitragess.

1.4.6 Licensees are encouraged to follow the relevant and applicable “Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services” (December 2009) and “Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services” (December 2006) issued by the Islamic Financial Services Board (IFSB).

1.5 General Requirements

1.5.1 Licensees shall declare that all their services are in compliance with Shari’a and must fulfil in particular the following criteria:

1.5.1.1 Appoint a Shari’a Supervisory Board (“SSB”) which shall oversee the operations of the Licensee from a Shari’a compliance perspective and prepare and present an annual Shari’a compliance report to the Board of Directors (“Board”). The SSB shall be assisted by a system of Shari’a Governance, explained in detail in the following pages of this Title.

1.5.1.2 Banks offering Islamic financial services through Windows, a branch or a number of branches that have separate accounts from their conventional branches, shall group those branches offering Islamic financial services together for financial reporting and shall prepare a consolidated supplementary set of accounting statements as per the standards issued by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI). These supplementary financial statements shall be published as an appendix in the notes to the financial statements of the institution.

1.5.1.3 The Islamic Window shall prepare a separate supplementary statement to be published in the notes to the financial statements showing in detail the funds mobilised according to the Shari’a rules and principles and the assets financed by these funds.

1.5.1.4 The Islamic Window shall prepare a supplementary statement to be published in the notes to the financial statements showing in detail the income and expenses related to the Islamic banking services offered by the Window.
1.6 Disclosure Requirements

1.6.1 Disclosure requirements are provided in detail in the Titles on Accounting Standards & Auditor Reports and Capital Adequacy.

1.6.2 Islamic Windows shall disclose in detail their sources and applications of funds mobilised and invested.

1.6.3 Islamic Windows must also disclose the sources of funds used to cover the deficit if it occurs.

1.6.4 Islamic Windows shall disclose any reserves deducted from the funds mobilized according to Shari’a principles, the purpose of such reserves and to whom these reserves shall revert to, in case the activities in respect of which such reserves were deducted have ceased.

1.6.5 Islamic Windows shall disclose the percentage of funds held by them from the parent and/or other conventional entities (in the form of capital allocated, deposits/IAH, etc.) in comparison to the total funds.

1.6.6 Islamic Windows shall disclose any other details as mandated by the Central Bank from time to time.
2. Shari’a Governance

2.1 Introduction

2.1.1 Shari’a Governance can be defined as a system whereby an Islamic financial institution attempts to comply with Shari’a in all its activities. Shari’a Governance is the hallmark and the differentiating factor for Islamic Banks and Islamic Windows which sets them apart from their conventional counterparts. It is the duty of all the stakeholders particularly the shareholders and the management of the Licensees to strengthen Shari’a Governance framework of their respective institutions. The main objectives of a Shari’a Governance framework are:

2.1.1.1 *To provide a structure and a system to govern all the business activities of the Licensee in order to ensure Shari’a compliance at all times and at all levels.*

2.1.1.2 *To enable the Licensee to be perceived as Shari’a compliant by the stakeholders including the general public.*

2.1.2 The key elements of a Shari’a Governance framework are as follows:

2.1.2.1 Shari’a Supervisory Board (“SSB”) of the Licensee

2.1.2.2 Internal Shari’a Reviewer

2.1.2.3 Shari’a Compliance unit

2.1.2.4 Shari’a Audit unit

2.1.3 Besides the above specific functions the Board and the management of the Licensee have a very important role to play in achieving and maintaining Shari’a compliance. Without adequate support of the Board and the management it is difficult for a financial institution to achieve Shari’a compliance.

2.1.4 The Board of the Licensee has the ultimate responsibility to create and maintain a robust Shari’a Governance framework to ensure Shari’a compliance of the operations of the Licensee. The Board shall approve all the policies and procedures for the Licensee related to Shari’a matters in consultation with the Shari’a Supervisory Board and shall put in place a mechanism to ensure that such policies and procedures are effectively implemented.

2.1.5 The Board shall ensure that the Head of Islamic Banking (in case of an Islamic Window) or the CEO (in case of a full-fledged Islamic Bank) of the Licensee has adequate knowledge, qualification and/or experience in Islamic banking and finance and possesses at least a basic understanding of Shari’a principles as they apply to Islamic banking products and processes.
2.1.6 The Head of Islamic Banking for an Islamic Window should be a senior and experienced person in the hierarchy of the organization. He should be at the level of General Manager, Deputy General Manager or Assistant General Manager (or relevant senior designation in line with the Licensee’s organizational structure), reporting directly to the CEO of the bank.

2.1.7 An Islamic Window shall have dedicated staff for various control functions including but not limited to credit administration, financial control (including for pool management), risk, etc. reporting to their respective department heads with dotted line reporting to the Head of Islamic Banking.

2.1.8 An Islamic Window shall have dedicated staff for business functions such as consumer and corporate, reporting to the Head of Islamic Banking. Treasurer may have dotted line interactions with Head of Treasurer of the bank subject of course to strict compliance on non-comingling and other requirements.

2.1.9 An Islamic Window may have shared support functions (e.g. legal, HR, central operations, admin, etc.) with its parent bank, for which a transparent cost allocation mechanism may be agreed.

2.1.10 The core banking system adopted by the Licensees shall be capable of recognizing the unique nature of Islamic banking contracts, transactions and processes. Within three years of start of operations the Licensees will ensure that their core banking system is duly certified to be Shari’a compliant by a credible third party. Licensees shall exercise necessary diligence in selecting an appropriate system notwithstanding the third party certification.

2.2 **Shari’a Supervisory Board**

2.2.1 **Appointment and Composition**

2.2.1.1 Licensees should establish their own SSBs. However, institutions of smaller size and less complexity may be allowed exceptionally to use an outsourced SSB subject to the acceptability and approval of the Central Bank.

2.2.1.2 A Shari’a Supervisory Board (or SSB) is an independent body of Shari’a scholars specialised in Fiqh al Mu’amalat (Islamic commercial jurisprudence). SSB may include additionally one or more non-voting members who are not specialised in Fiqh al Mu’amalat but have expertise in Islamic banking (or related areas like finance, economics, accounting, law, etc.) and possess basic knowledge of Fiqh al Mu’amalat. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the Licensee in order to ensure that they are in
compliance with Shari’a principles. The Fatawa and rulings of the SSB shall be binding on the Licensees.

2.2.1.3 The SSB shall comprise of a minimum of three Shari’a scholars as above. All rulings (Fatawa) of the SSB shall be backed by the majority of the Shari’a scholars as detailed in Attachment 5.2 (Operational Procedures for Shari’a Supervisory Board).

2.2.1.4 Foreign banks licensed to do Islamic banking in Oman should demonstrate acceptability of their SSBs with the standards and norms set hereunder.

2.2.1.5 Licensees are encouraged to develop Omani expertise in Shari’a scholarship as well as in Islamic banking related finance, economics, accounting, law etc., so as to facilitate progressive increase in membership of Omanis in SSBs.

2.2.1.6 The general assembly of the bank shall make a decision of appointing members of SSB and fixing their remuneration. Such remuneration shall be disclosed for each SSB member in the annual report.

2.2.1.7 The appointment of SSB members shall be formally documented in the shape of a formal offer letter signed by the authorized representative of the Board. The letter of appointment of SSB should include reference to the compliance of the Licensee with Shari’a principles.

2.2.2 Roles and Responsibilities of the SSB

2.2.2.1 The SSB shall be the ultimate responsible authority within the Licensee for all Shari’a related matters. The Board of Directors of the Licensee, which bears the responsibility of overall governance of the institution, shall rely on the SSB for all matters relating to Shari’a in the normal course of business and operations of the Licensee.

2.2.2.2 The SSB shall use the various elements of Shari’a Governance framework in order to fulfil its responsibilities, i.e. Internal Shari’a Reviewer, Shari’a compliance unit and Shari’a audit unit. The SSB shall receive reports from Shari’a audit function periodically and use them in its assessment and decisions.

2.2.2.3 A charter shall be prepared by the Licensee and approved by the Board defining the scope of work for the SSB. A typical charter of the SSB shall cover, at a minimum, the following:

2.2.2.3.1 Purpose of the Charter;
2.2.2.3.2 Membership of the SSB;
2.2.2.3.3 Composition of the SSB;
2.2.2.3.4 Chairperson;
2.2.2.3.5 Secretary;
2.2.2.3.6 Possible cause/course of removal and replacement of a Member;
2.2.2.3.7 Responsibilities of the Shari’a Supervisory Board;
2.2.2.3.8 Meetings / meeting frequency;
2.2.2.3.9 Quorum;
2.2.2.3.10 Agenda;
2.2.2.3.11 Meeting minutes;
2.2.2.3.12 Voting and decisions;
2.2.2.3.13 Authority of the Shari’a Supervisory Board;
2.2.2.3.14 Authorization of the charter;
2.2.2.3.15 Amendments to the document.

2.2.2.4 The responsibilities of the SSB shall include but will not be limited to the following:

2.2.2.4.1 Advise the Board and the management on Shari’a matters in the day to day business of the Licensee;
2.2.2.4.2 Review and approve all the policies & procedures, products, processes, systems, contracts and agreements for their Shari’a compliance (to be ratified subsequently by the Board);
2.2.2.4.3 Review and approve product documentation (including product features, terms & conditions, underlying Islamic contracts, product manual, marketing, collateral, other legal documentation, etc.);
2.2.2.4.4 Conduct Shari’a checks post product approval to ensure implementation of the related guidelines as approved by the SSB;
2.2.2.4.5 Review and approve the work carried out by Shari’a compliance and Shari’a audit functions;
2.2.2.4.6 Guide related parties on Shari’a matters (e.g. legal counsel, external auditor, etc);
2.2.2.4.7 Provide written Shari’a opinion / ruling on matters brought to its attention by the management of the Licensee through Internal Shari’a Reviewer or taken up by the SSB itself;
2.2.2.4.8 Submit a report to the Board of Directors on the Licensee’s Shari’a compliance to be published as part of the annual report.

2.2.2.5 The SSB’s report should at least contain the following basic elements:

2.2.2.5.1 Title;

2.2.2.5.2 Addressee;

2.2.2.5.3 Opening or introductory paragraph;

2.2.2.5.4 Scope paragraph describing the nature of the work performed;

2.2.2.5.5 Opinion paragraph containing an expression of opinion on the compliance of the Licensee with Shari’a rules and principles;

2.2.2.5.6 Date of report; and

2.2.2.5.7 Signature of the members of Shari’a Supervisory Board.

2.2.2.6 A measure of uniformity in the form and content of the SSB’s report is desirable because it helps to promote the reader’s understanding and to identify unusual circumstances when they occur.

2.2.2.7 The opinion paragraph of the report as mentioned above should contain the following:

2.2.2.7.1 Whether or not the SSB has examined, to a reasonable extent on test case basis, each class of transaction, the relevant documentation and procedures adopted by the Licensee;

2.2.2.7.2 Whether or not in the SSB’s opinion, the affairs of the Licensee have been carried out in accordance with the rules and principles of Shari’a, Central Bank’s regulations and guidelines related to Shari’a compliance and other rules as well as with specific Fatawa and rulings issued by the SSB from time to time;

2.2.2.7.3 Whether or not in the SSB’s opinion, the allocation of funds, weightages, profit sharing ratios, profits and charging of losses (if any) relating to investment accounts conform to the basis given by the SSB in accordance with Shari’a rules and principles;

2.2.2.7.4 Whether or not in the SSB’s opinion, any earnings that have been realized from sources or means prohibited by Shari’a rules and principles have been credited to the charity account in a manner prescribed by the SSB. See Attachment 5.3 for a sample SSB report.

2.2.2.8 SSB shall define the key elements to be evaluated while reviewing and approving a new product. Such key elements shall be used as the minimum guidelines /
checklist by Internal Shari’a Reviewer while reviewing all new products and services, before presenting the product / service document to the SSB. This checklist shall include, at a minimum, key features of the product, processes, structure, documentation (including legal contracts), risk and compliance considerations, marketing, collateral and other such necessary details as required to ensure proper business understanding. The SSB shall advise on the Shari’a compliance of the proposed product / service backed by relevant Fiqh literature, evidence and reasoning.

2.2.2.9 SSB members shall allocate appropriate time and effort to understand fully the issues under consideration. They are expected not to compromise the rigour of the Shari’a ruling process due to commercial or business pressures.

2.2.2.10 SSB members shall hold substantive and meaningful consultations amongst themselves and with the various stakeholders (and if need be, with outside experts) in order to arrive at a decision on an issue. In case of new product development SSB members shall provide an opportunity to internal and external auditors, lawyers and others involved in the process to express their views. Shari’a scholars are encouraged to give due consideration to the economic, societal and other aspects of the issue under discussion in order to reach a Shari’a ruling (Fatwa) which follows the spirit and substance of the Shari’a as well as its form. The management and the Board of the Licensee are expected to support the SSB in the above process in any way needed.

2.2.2.11 If the SSB has reason to believe that Shari’a non-compliant activities are being carried out in a systematic manner within the Licensee, the SSB shall inform the Board and suggest suitable measures to rectify the situation.

2.2.2.12 If Shari’a non-compliant activities continue despite the above measures or if the Board fails to effectively address the concerns of the SSB, the SSB shall inform the Central Bank and report such violations in its annual Shari’a compliance report to the Board.

2.2.2.13 The SSB shall document its Shari’a rulings (Fatawa) and guidelines which shall be maintained centrally for ready reference and disseminated and implemented within the Licensee.

2.2.2.14 The SSB shall also publish as an appendix to its annual Shari’a compliance report all the Shari’a rulings (Fatawa) issued during a year along with their bases (religious evidence).
2.2.2.15 The SSB members shall keep confidential the privileged and sensitive information they come across or given to them or obtained by them in the course of their working as SSB members.

2.2.2.16 Confidential information includes, but is not limited to, the following:

2.2.2.16.1 Information on the development of new products or services or a transaction that has not yet taken place or not yet made public;

2.2.2.16.2 Decisions of the SSB or Board of Directors or management;

2.2.2.16.3 Internal memoranda or reports prepared by the management in connection with matters presented to the SSB;

2.2.2.16.4 Discussions and deliberations of the SSB among its members or with the management of the Licensee;

2.2.2.16.5 Any information or data about the Licensee’s clients attracting customer confidentiality provisions of the Banking Law;

2.2.2.16.6 Any other matter which the management has legitimately requested not to be made public.

2.2.3 “Fit and Proper” Criteria for the Members of the SSB

2.2.3.1 Members of the SSB have to be Muslim individuals.

2.2.3.2 Members of the SSB with Shari’a background must be holders of academic qualifications in the field of Shari’a – minimum of bachelor degree – that include study in Usul ul Fiqh (Rules of Islamic jurisprudence) and Fiqh al Mu’amalat (Islamic commercial jurisprudence) from a recognized institution. They should be able to demonstrate an adequate understanding of finance / banking in general and Islamic finance / banking in particular. They should also be able to demonstrate an understanding of the legal and regulatory framework applicable to the functions of the Licensee.

2.2.3.3 Shari’a scholars must have accumulated overall experience of 10 years or more (in teaching, research, Fatwa issuance, etc.) to be eligible to become members of a SSB. They should be able to demonstrate strong proficiency in Arabic. It is recommended that they have reasonable understanding of English.

2.2.3.4 Members of the SSB other than Shari’a scholars must be individuals generally recognized for their expertise in their respective field (e.g. economics, law, banking, accounting, finance, etc.). They should hold a minimum of master degree. They should have accumulated relevant experience of 15 years or more in
the relevant field. They should be able to demonstrate reasonable proficiency in English. It is recommended that they have some understanding of Arabic.

2.2.3.5 Members of the SSB must have a respectable character and be of good conduct, particularly in terms of honesty, integrity and reputation in their professional business and financial dealings.

2.2.4 Term of SSB

2.2.4.1 Members of the SSB shall be appointed for a maximum initial term of three years which can be renewed for another 3-year term. A SSB member can serve a maximum of two consecutive terms in an institution.

2.2.5 Diligence of SSB Members, Conflicts of interests and Change

2.2.4.2 The SSB shall be independent, objective, competent and appropriately empowered to carry out its responsibilities. Necessary measures shall be taken to ensure that the SSB not only works independently but is also seen to be independent by the stakeholders including the general public.

2.2.4.3 Independence, for the purpose of this title, is “an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and objectivity”.

2.2.4.4 SSB members have a responsibility to the public, which relies on the credibility and independence of the SSB while using the services of the Licensee. The public includes clients, credit grantors, governments, employers, employees, investors and others who rely on the objectivity and integrity of SSB members to ensure Shari’a compliance with regard to activities of the Licensee.

2.2.4.5 SSB members are solely and personally responsible for their own work as members of the SSB.

2.2.4.6 SSB members shall always strive to uphold fairness and equity for all the stakeholders.

2.2.4.7 SSB members shall exercise appropriate discretion in decision making by keeping in mind both the technical aspects of Shari’a and the objectives of Shari’a (Maqasid-e-Shari’a). They should pay attention to both the legal and the ethical dimensions of their decisions.

2.2.4.8 SSB members shall appreciate the diversity of opinions among various mainstream schools of thought and differences in expertise among the fellow members of the SSB. No one member should dominate the SSB decisions.
2.2.4.9 SSB members should continuously assess their relationships with the Licensee to identify any situations that may impair independence and resolve it or report to the SSB such situations in which an issue of independence impairment is present or may reasonably be inferred, and agree on an action plan to resolve such issues.

2.2.4.10 When faced with potential and/or actual issue of independence impairment SSB members should do the following to resolve the issue:

2.2.4.10.1 Document the issue;

2.2.4.10.2 Review the issue internally within the SSB and take necessary steps to resolve the issue;

2.2.4.10.3 If the issue still exists after the internal review by the SSB, the SSB member with the issue of independence impairment must resign and the General Assembly of the Licensee must be notified.

2.2.4.11 The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests.

2.2.4.12 Objectivity is an independent mental attitude which SSB members should maintain in performing Shari’a supervision. SSB members shall not subordinate their judgment on Shari’a supervision matters to that of others.

2.2.4.13 Objectivity requires SSB to perform Shari’a supervision in such a manner that they have an honest belief in their work. SSBs should avoid potential and actual situations that impair their ability to make objective professional judgments.

2.2.4.14 SSB members should neither be employees of the Licensee, nor should they be involved in any manner with regard to managerial decisions and operational responsibilities of the Licensee.

2.2.4.15 The Board of the Licensee shall devise a satisfactory mechanism for an annual check of SSB members for independence and conflict of interest. The Board shall also carry out an annual assessment of the SSB members (including attendance of Shari’a board meetings, among other criteria) and submit the assessment report to the Central Bank. (See Attachment 5.4 for a sample performance assessment).

2.2.4.16 Conflict of interest may arise in the following situations, as an example: Where the SSB member acts contrary to his obligation and to his fiduciary duty towards the Licensee, or if the SSB member exploits his position for his own personal and pecuniary benefit.

2.2.4.17 The SSB members shall not have any relationship with the Licensee that could possibly be seen to interfere or reasonably be perceived to interfere with the
exercise of their independent judgment when delivering Fatawa and rulings in Shari’a.

2.2.4.18 No SSB member can be on the Shari’a Supervisory Boards of more than one competing institution in Oman. However, a SSB member can be on the Shari’a Supervisory Boards of more than one non-competing institutions (e.g. the SSB member of an Islamic Bank can also sit on the SSB of a Takaful company or an Islamic fund management company, etc.). Overall, no SSB member can be on the SSBs of more than four institutions in Oman.

2.2.4.19 *The Central Bank may review this provision from time to time in consultation with other concerned authorities / regulators in the Sultanate.*

2.2.4.20 Relationships of SSB members

2.2.4.21 A member of the SSB cannot be an employee of the Licensee or any of its related companies for the current or the last financial year. Similarly, a member of the SSB cannot be a Director in the same institution or its associate / affiliate companies for the current or the last financial year.

2.2.4.22 Members of SSB shall not have any relationship that could interfere or be reasonably perceived to interfere with the exercise of independent professional judgment. Such relationships include, but are not limited to:

2.2.4.22.1 An immediate family member (of first degree blood relationship) who is or who was during the last financial year employed by the Licensee or any of its related companies as CEO or director or any other key management position.

2.2.4.22.2 An immediate family member (of first degree blood relationship) who is a substantial (10% or higher) shareholder of or an executive officer in any organization which the Licensee made to or received from significant payments (RO 10,000 or more) in the current or immediate past financial year.

2.2.4.23 A SSB member is allowed to become a depositor / investment account holder of the Licensee or seek financing facilities from the Licensee in the normal course of business. However, no special rates or treatment shall be given to SSB members in such cases. All such relationships shall be disclosed in the annual report of the Licensee.

2.2.4.24 *The SSB may engage on a case by case basis other experts from outside the SSB for specific technical advice on a particular issue, if required.*
2.2.4.25 The SSB members should preferably come from diverse backgrounds in terms of areas of expertise, qualifications and experience in order to enhance the depth and breadth of Shari’a deliberations at the SSB.

2.2.4.26 SSB members should be familiar with and reckon domestic legal and regulatory environment and sensitivities.

2.2.4.27 SSBs are encouraged to adopt the “Basic Professional Ethics and Conduct for Members of the Shari’a Board” as per IFSB Guiding Principles on Shari’a Governance Systems for Institutions Offering Islamic Financial Services, December 2009.

2.2.5 Grounds for disqualification of SSB members

2.2.5.1 A SSB member can be disqualified from the SSB of a Licensee based on certain grounds, including but not limited to:

2.2.5.1.1 SSB members must be individuals of good character and reputation, holding a position of respect amongst their peers. If this ceases to be the case, a SSB member can be disqualified;

2.2.5.1.2 If a SSB member fails to attend a substantial number (at least 75% or as determined by the Central Bank from time to time) of the meetings set out in a year without a reasonable excuse;

2.2.5.1.3 If a SSB member is associated with any unethical or illegal activity including contravening any of the requirements and standards of the financial, banking or corporate regulatory system;

2.2.5.1.4 If a SSB member is convicted of any criminal offence including financial impropriety or moral turpitude (except misdemeanors);

2.2.5.1.5 If a SSB member had been dismissed in the capacity of employee or director from any institution or company on the grounds of fraud, misrepresentation or breach of trust;

2.2.5.1.6 If a SSB member assumes membership in the Shari’a Supervisory Boards of two or more competing financial institutions in Oman;

2.2.5.1.7 If a SSB member uses confidential and privileged information about the Licensee or its clients obtained as a result of his position and uses it in a manner that is detriment to the competitive interests of the Licensee in the market place.

2.2.5.2 Advice to the Central Bank
2.2.5.3 The dismissal of a member of the SSB shall require a recommendation by the Board of Directors and be subject to the approval of the shareholders in a general meeting.

2.2.5.4 The Licensee shall notify the Central Bank of any resignation or removal of a SSB member as and when it happens or when action is contemplated / initiated, whichever is earlier, stating the reasons and actions, including replacement proposed.

2.2.5.5 Licensees concerned shall have members of the SSB, whose accounts are classified, removed in accordance with relative provisions on Directors stated in the Title on Credit Risks.

2.2.6 Management’s duties to the SSB

2.2.6.1 While the SSB is responsible for forming and expressing an opinion on the extent of a Licensee’s compliance with Shari’a, the responsibility for compliance rests with the management of the Licensee. To enable management to carry out this responsibility effectively, the SSB of the Licensee shall assist by providing guidance and advice relating to compliance with Shari’a. The presence of SSB and Shari'a compliance function of a Licensee does not relieve the Licensee’s management of its responsibility to undertake all transactions in accordance with Shari’a.

2.2.6.2 Management shall be responsible for observing and implementing Shari’a rulings and decisions passed by the SSB.

2.2.6.3 Management is responsible to provide complete disclosure and access to necessary information to the SSB via Internal Shari’a Reviewer in a timely manner, failing which they can be penalized by the Board of Directors (which has overall responsibility to ensure the implementation of Shari’a Governance framework and related operations).

2.2.6.4 Management is responsible to allocate adequate resources (including people, systems and processes) to support the Shari’a governance framework.

2.2.6.5 Management will ensure that Shari’a guidelines and Fatawa issued by the SSB are accessible at all times to those involved in the actual implementation process as well as other stakeholders.

2.2.6.6 If an instance occurs of Shari’a non-compliance and this comes to the Management’s attention, immediate remedial action as mentioned below must be taken:
2.2.6.6.1 The Internal Shari’a Reviewer and the SSB should be notified immediately;

2.2.6.6.2 The Licensee shall immediately cease to take on any new business related to Shari’a non-compliant elements inherent in the business;

2.2.6.6.3 Management shall act on the advice of the Internal Shari’a Reviewer and/or the SSB to rectify the non-compliance and take measures to ensure that recurrence of such nature does not happen in the future.

2.2.6.7 SSB shall develop an annual training program for its members in order to plug any knowledge gaps in banking, finance, economics or other related disciplines for SSB members with Shari’a background and Shari’a related knowledge for SSB members who are experts in their respective fields but do not have adequate knowledge of Shari’a. The management shall be responsible to arrange the necessary logistics for such training.

2.2.7 Miscellaneous

2.2.7.1 Each Licensee has to create and maintain a Charity Fund in which income from Shari’a non-compliant sources or penalties and late payment charges received from clients in default or overdue cases etc. will be credited. SSB shall supervise the inflows and outflows of the Charity Fund.

2.2.7.2 Such funds may be deposited in a Shari’a compliant remunerative account at the discretion of the Internal Shari’a Reviewer.

2.2.7.3 The amount in this Fund will be utilized for charitable and social welfare purposes in accordance with the policy devised by the management, vetted by the Internal Shari’a Reviewer and approved by the SSB.

2.2.7.4 It shall be ensured that no amount of charity fund can be directed to or utilized by persons (including their spouses, dependents and children) directly or indirectly connected with the Licensee, including the senior Management of the Licensee, the Board of Directors, the SSB members and spouses and dependents thereof.

2.2.7.5 The Licensee shall maintain proper accounts and records regarding all transactions relating to the Charity Fund. It will disclose the inflows and outflows of the Charity Fund in its annual audited financial statements through a Statement of Sources and Uses of Charity Fund (see Attachment 5.3). Each outflow shall require the approval of the SSB.

2.2.7.6 Amount available in the Charity Fund shall normally be utilized by the Licensee within the same accounting year in which it was accrued. In special cases where
there is a justifiable reason to delay the disbursement to the subsequent year, the Licensee may do so after the approval of the SSB.

2.3 **Internal Shari’a Reviewer**

2.3.1 **Appointment and removal**

2.3.1.1 Internal Shari’a Reviewer shall be appointed by the management in consultation with the SSB. Such appointment shall be approved by the Board of the Licensee (Country Manager in consultation with Head Office / Regional Office in the case of foreign Licensee).

2.3.1.2 The management may terminate the employment of the Internal Shari’a Reviewer with the approval of the Board of the Licensee in consultation with the SSB (in case of a foreign Licensee, the management may take this decision in consultation with the foreign Licensee’s global SSB).

2.3.1.3 Internal Shari’a Reviewer shall be a full time employee of the Licensee.

2.3.1.4 Licensees are required to notify the Central Bank of any resignation or termination of the Internal Shari’a Reviewer immediately when it occurs or cause of action is known, whichever is earlier. Licensees shall also state the reasons of such termination or resignation and alternate arrangements for the interim period. The Licensee shall arrange for an exit interview with the Central Bank if requested.

2.3.2 **Roles & responsibilities**

2.3.2.1 Internal Shari’a Reviewer shall have the responsibility to head the Shari’a compliance unit as well as the Shari’a audit unit of the Licensee. He shall be a qualified Shari’a scholar. He shall be assisted by a team of Shari’a compliance officers and Shari’a audit officers who shall have knowledge and experience of the banking business as well as basic orientation to and understanding of Shari’a (in particular Fiqh al Mu’amalat) as applied to the banking and audit processes.

2.3.2.2 Internal Shari’a Reviewer shall work independently and report to the SSB, with administrative reporting to the CEO (of a full-fledged Islamic Bank) or Head of Islamic Banking (in case of an Islamic Window).

2.3.2.3 Internal Shari’a Reviewer shall be responsible for providing Shari’a guidance and direction in day-to-day matters to the Licensee’s management. He may escalate an issue to the SSB to seek their guidance and approval if deemed appropriate or necessary. (However, this does not take away from the SSB their right to take up any issue on their own).
2.3.2.4 Internal Shari’a Reviewer and his team of Shari’a compliance officers and Shari’a audit officers shall have access to all records, documents and information from all sources including professional advisors and the Licensee’s employees in discharge of his duties. The management shall be responsible to provide him with all the information relating to the Licensee’s compliance with Shari’a.

2.3.2.5 Internal Shari’a Reviewer shall also oversee the Shari’a training plans and schedule for the Licensee. He shall spend a significant percentage of his time, on an annual basis, in training the management and the staff of the Licensee and other stakeholders (including customers and the general public, among others) on Shari’a as it applies to Islamic banking. A log of his time spent on training shall be kept by the Licensee and shall be made available to the Central Bank, if required.

2.3.2.6 Internal Shari’a Reviewer is expected to cultivate a culture of compliance in the organization and of research within the Shari’a compliance unit. He shall produce at least one research paper every year to be published in a journal of regional or international repute.

2.3.2.7 The legal counsel, auditor or consultant of a Licensee may seek advice on Shari’a related matters from the Internal Shari’a Reviewer.

2.3.3 **Fit & proper criteria**

2.3.3.1 Internal Shari’a Reviewer shall fulfil the “Fit & Proper” criteria of SSB members as outlined in this Title, except that the minimum experience requirement is 5 years.

2.3.3.2 Internal Shari’a Reviewer shall be a full time employee of the Licensee and can only work for one Licensee at a time in his capacity as Internal Shari’a Reviewer. He cannot be a member of the Licensee’s SSB at the same time.

2.4 **Shari’a Compliance Unit**

2.4.1 **Roles and responsibilities**

2.4.1.1 Licensees are required to introduce a Shari’a compliance unit as part of their Shari’a Governance framework, reporting to the Internal Shari’a Reviewer.

2.4.1.2 Shari’a compliance unit will facilitate the management in ensuring compliance with Shari’a (as manifested by the guidelines and Fatawa issued by the SSB) and Islamic banking stipulations of the Central Bank on a day to day basis in all its business activities, operations and transactions. This shall be done through review
and approval of the contracts, agreements, policies, procedures, products, process flows, transactions, reports (profit distribution calculations), etc.

2.4.1.3 Shari’a compliance unit shall be extensively involved before a new product or transaction is approved. No new product class or transaction type shall be executed without first consulting the Shari’a compliance unit and getting a formal approval from the SSB.

2.4.1.4 Shari’a compliance unit shall ensure that it receives regular MIS and confirmations from the business departments and branches relating to the Shari’a compliance of key transactions and the actions taken to resolve any observations raised by the Shari’a compliance unit on the operations, products or procedures. At a minimum, this MIS can be in the shape of a reporting checklist of key Shari’a issues for various contract and transaction types, drafted by the Shari’a compliance unit, which shall be duly filled in and submitted by the relevant business department (or branch) on a regular basis to ensure ongoing Shari’a compliance. The purpose of this reporting is to minimize the possibility of Shari’a non-compliance and rectify any such issues (where possible) during the year before Shari’a audit identifies them in their annual Shari’a audit.

2.4.1.5 Shari’a compliance shall also include Shari’a risk control whereby an appropriate senior resource shall identify, measure, monitor, control and manage (with guidance from Internal Shari’a Reviewer) any real or perceived risk of Shari’a non-compliance by the Licensee across the entire organization including fundamental (or primary) as well as tertiary (or peripheral) activities, operations and functions. Such senior resource may be part of the risk management department of the Licensee with dotted line reporting to the Internal Shari’a Reviewer.

2.4.1.6 Shari’a compliance unit shall be adequately resourced (depending on the size and complexity of the Licensee) to undertake Shari’a research.

2.4.1.7 Shari’a compliance unit shall participate in training the employees of the Licensee – both management and staff – and other stakeholders including customers and the general public. For this purpose they will conduct training courses, seminars and conferences, among others. They may also disseminate knowledge by publishing and distributing pamphlets, brochures, etc. explaining the principles of Islamic banking and the Fatawa, guidelines and instructions issued by their SSB about the products and services offered by the Licensee.

2.4.2 **Fit & proper criteria for Shari’a compliance staff**
2.4.2.1 The Shari’a compliance officers are required to have sound banking knowledge and understanding as well as understanding of Shari’a principles in general and Fiqh al Mu’amalat in particular. They should have appropriate educational background and training relevant to their work.

2.4.2.2 The Licensee shall have a system in place which ensures that only qualified, experienced and committed employees are recruited and retained in the Shari’a compliance unit. The system shall ensure that employees are continuously trained and developed in related disciplines, especially Fiqh al Mu’amalat. Their performance shall be regularly assessed and appropriate action shall be taken based on recommendations from the Internal Shari’a Reviewer and the SSB.

2.4.2.3 The management of the Licensee shall provide all the needed support to facilitate appropriate training of Shari’a compliance officers in order to enable them to carry out their duties with competence and rigour. Such training should be arranged in consultation with / significant input from Internal Shari’a Reviewer and the SSB. Shari’a compliance officers shall maintain their technical competence through continuing education to keep themselves informed about improvements and current developments in the Islamic finance industry in particular and the economy in general.

2.5 Shari’a Audit Unit

2.5.1 Roles & responsibilities

2.5.1.1 Licensees shall establish a Shari’a audit unit as part of their Shari’a Governance framework, reporting to the Internal Shari’a Reviewer.

2.5.1.2 The Shari’a audit unit is responsible to assist the Internal Shari’a Reviewer and the SSB in forming or expressing an opinion on the extent of the Shari’a compliance of the Licensee’s operations. It will examine and evaluate the extent of compliance with Shari’a principles, Fatawa, guidelines and instructions issued by the Licensee’s SSB through an actual audit of the business transactions.

2.5.1.3 Internal Shari’a audit is an integral part of the Licensees’ Shari’a governance framework and operates under the policies established by the SSB. It shall have a statement of purpose, authority and responsibility (charter). The charter shall be prepared by the management, approved by the SSB and issued by the Board of Directors. The charter shall make clear that Shari’a audit officers shall have no executive authority or responsibility for the activities they audit. The charter shall be regularly reviewed and updated as required.
2.5.1.4 The scope of work of internal Shari’a audit shall encompass the examination and evaluation of the adequacy and effectiveness of the Licensee’s system of Shari’a compliance and the quality of performance in carrying out assigned responsibilities. The scope of internal Shari’a audit shall cover all aspects of the Licensee’s business operations and activities, including review of the products, processes, agreements and systems for assessing the extent of implementation of the Shari’a guidelines and Fatawa issued by the SSB.

2.5.1.5 The Shari’a audit officers shall have direct and regular communications with all levels of management, Internal Shari’a Reviewer, SSB and external auditors. No scope limitation and/or restriction of access to documents, reports, etc. shall be placed on Shari’a audit officers.

2.5.1.6 Shari’a audit officers shall be objective and maintain independent attitude in performing their internal Shari’a audit. They shall reach objective conclusions based on work performed and the results thereof.

2.5.1.7 Shari’a audit officers shall exercise due professional care in performing their work. Professional care shall be appropriate to the complexities of the internal Shari’a audit being performed. In exercising due professional care, Shari’a audit officers shall be alert to the possibility of intentional wrongdoing.

2.5.1.8 The Internal Shari’a Reviewer shall be responsible for providing appropriate supervision throughout internal Shari’a audit, starting from the planning stage. Appropriate evidence of supervision shall be documented and retained.

2.5.1.9 Internal Shari’a audit planning process shall include, but is not limited to, the following:

2.5.1.9.1 Obtaining background information about the activities to be audited, such as locations, products/services, branches, divisions, etc;

2.5.1.9.2 Establishing internal Shari’a audit objectives and scope of work;

2.5.1.9.3 Obtaining SSB Fatawa, guidelines, instructions, prior year internal and external Shari’a audit results, relevant correspondence including with supervisory and regulatory agencies;

2.5.1.9.4 Determining the resources necessary to perform internal Shari’a audit;

2.5.1.9.5 Communicating with all the individuals at the Licensee who need to know about internal Shari’a audit;
2.5.1.9.6 Performing, as appropriate, a survey to become familiar with activities, risks and controls to identify areas of internal Shari’a audit emphasis, and to invite comments and suggestions;

2.5.1.9.7 Writing internal Shari’a audit programs;

2.5.1.9.8 Determining how and when internal Shari’a audit results shall be communicated;

2.5.1.9.9 Obtaining approval of internal Shari’a audit work plan from the SSB (or Internal Shari’a Reviewer on behalf of the SSB) and implementing Shari’a audit programs through actual audit;

2.5.1.9.10 Sharing the draft report with Internal Shari’a Reviewer for clarification and rectification of issues raised;

2.5.1.9.11 Finalization of internal Shari’a audit report for presentation to the SSB.

2.5.1.10 Shari’a audit officers shall collect, analyse, interpret and document information to support their internal Shari’a audit results. Information shall be collected on all matters related to internal Shari’a audit objectives and scope of work. Information collection shall include examination of documentation, analytical reviews, inquiries, discussions with management and observations.

2.5.1.11 Information shall be sufficient, reliable, relevant and useful to provide a sound basis for internal Shari’a audit findings and recommendations. Working papers that document the work carried out by the internal Shari’a audit unit shall be prepared by the Shari’a audit officers and reviewed by the Internal Shari’a Reviewer. These working papers shall support internal Shari’a audit findings and recommendations. Working papers shall be appropriately prepared, completed, organised, reviewed and retained.

2.5.1.12 The internal Shari’a audit team shall discuss findings, recommendations and conclusions with the Internal Shari’a Reviewer and appropriate levels of management before issuing the final written report. On completion of internal Shari’a audit, at least a quarterly written report shall be prepared which must be signed by the Internal Shari’a Reviewer, addressed to the SSB and copied to the management.

2.5.1.13 The internal Shari’a audit report shall include observations and assessment of systems and controls the Licensee has in place for Shari’a compliance.

2.5.1.14 Any difference of opinion between the management and the Shari’a audit officers on matters relating to Shari’a interpretation shall be referred to the Internal
Shari’a Reviewer and the SSB (if required). SSB shall be the final authority on matters of Shari’a interpretation.

2.5.1.15 The report prepared by internal Shari’a audit unit shall be presented to the SSB of the Licensee for consideration and appropriate action. A copy of the report shall also be presented to the Audit Committee of the Board.

2.5.1.16 The report shall be objective, clear, constructive and timely. The report shall present the purpose, scope and results of internal Shari’a audit and it shall contain an expression of internal Shari’a auditor’s opinion. The report shall also include recommendations for potential improvements and corrective actions, and acknowledge satisfactory performance, when appropriate.

2.5.1.17 Shari’a audit officers shall follow up to ascertain that appropriate action is taken on their reported findings and recommended corrective actions. In addition, any other recommendations relating to Shari’a matters made by the SSB, external auditors and/or regulatory agencies shall also be followed up. The management is responsible for rectification of non-compliance, its prevention in the future and ensuring that the agreed upon actions were carried out.

2.5.1.18 The Internal Shari’a Reviewer shall properly manage internal Shari’a audit. His duties shall include establishing plans to carry out the responsibilities of internal Shari’a audit, providing written policies and procedures to guide his staff and establishing a program for selecting and developing their performance.

2.5.1.19 In case of an Islamic Window, internal Shari’a audit unit shall also make an assessment as to whether the funds have been adequately segregated and that the services and transactions with the conventional parent (if any) are Shari’a compliant and in accordance with the guidelines issued by the SSB and related rules of the Central Bank.

2.5.1.20 Shari’a audit officers shall assist the Shari’a compliance unit in training the employees of the Licensee and/or other stakeholders if required.

2.5.1.21 The Central Bank shall add Shari’a audit as an additional component to its regular annual examination and audit of the Licensees.

2.5.1.22 The Licensees shall engage an independent third party to conduct an annual external independent Shari’a audit. The purpose of this audit is to add credibility to the internal Shari’a audit of the Licensees through an independent endorsement. This will also enhance public confidence in the Shari’a legitimacy of the Licensees.
2.5.1.23 An independent Shari’a audit shall be similar in scope as internal Shari’a audit. It is not meant to provide an opinion on the Shari’a legitimacy of the SSB’s decisions. It will only assess the extent of implementation by the Licensee’s management of the decisions given by the SSB.

2.5.1.24 Independent Shari’a auditor shall submit its report to the Board of Directors of the Licensee and the Central Bank, with a copy to the SSB and management of the Licensee.

2.5.2 **Fit & proper criteria for internal Shari’a audit staff**

2.5.2.1 The staff of internal Shari’a audit unit shall be proficient and shall have appropriate educational background and training relevant to their work. Proficiency in Shari’a principles in general and Fiqh al Mu’amalat in particular is required in performing internal Shari’a audit. Shari’a audit officers shall maintain their technical competence through continuing education to keep themselves informed about improvements and current developments in the Islamic finance industry in particular and the economy in general. The Internal Shari’a Reviewer shall establish suitable criteria to meet the above.

2.5.2.2 The Licensee shall have a system in place which ensures that only qualified, experienced and committed employees are recruited and retained in internal Shari’a audit unit. The system shall ensure that employees are continuously trained and developed in related disciplines, especially Fiqh al Mu’amalat. Their performance shall be regularly assessed and appropriate action shall be taken based on recommendations from the Internal Shari’a Reviewer and the SSB.

2.5.2.3 The management of the Licensee shall provide all the needed support to facilitate appropriate training of its internal Shari’a audit resources in order to enable them to carry out their duties with competence and rigour. Such training should be arranged in consultation with / significant input from Internal Shari’a Reviewer and the SSB.
3. Corporate Governance for Licensees

3.1 Applicable Law

3.1.1 Islamic Banks and Islamic Windows must follow the Corporate Governance rules given in this document. They should also follow the Code of Corporate Governance by the Capital Market Authority (“CMA”).

3.1.2 General Principles

3.1.3 Sound corporate governance principles shall include establishment of corporate governance policy framework setting out rules and functions for each organ, balancing accountability for various stakeholders including Investment Account Holders, due diligence in the management of investment accounts and appropriate disclosures covering both financial and non-financial information and compliance with Shari’a principles in letter and spirit.

3.1.4 The management of risks in the organisation and creation of appropriate control environment with business goals and conduct shall be ensured.

3.2 Principles of Demarcation

3.2.1 Corporate governance rules are meant to lay down the principles of demarcation between the role, responsibility and accountability of the Board of Directors and that of the management in the Licensees incorporated within the Sultanate of Oman.

3.3 Role and Responsibility of the Board of Directors

3.3.1 Policy Formulation

3.3.1.1 The Board shall engage in policy formulation, based upon a corporate vision subject to all on-going review in dynamic surroundings consisting of political, economic, social and environmental considerations. In order to ensure effective management of the Licensee, the Board should give management a clear set of principles that underpin its strategic objectives and financial plan. Typically, major policy areas include resource mobilization, credit, treasury, risk management and professional liability (e.g. trust, funds management, financial advisory service, etc.) and related party transactions.
3.3.1.2 The Board shall encourage the line management suggestions which are to be based on field level operational experiences towards policy formulation and shall examine those objectively to enhance and sharpen policy formulation.

3.3.1.3 The Board shall demand from the management in-depth study papers on subject of topical interest impacting the corporate entity to serve as in-house inputs into policy formulation.

3.3.1.4 In case of a perceived need, the Board shall draw upon external professionals and intellectuals selectively to augment in-house resources for policy formulation.

3.3.1.5 The Board shall exercise its collective mind independently on all policy matters and shall not get limited by the submissions or presentations made to it.

3.3.1.6 The Board shall not predetermine the policy issues and shall not convey its inclinations while calling for inputs for policy formulation internally and / or externally. Making the Board inclinations known to the providers of policy inputs could mar their objectivity and affect quality of decision making.

3.3.1.7 The Board shall ensure that it has an organisation structure in place to provide adequate checks, balances and functionality for guarding the Licensee from undue influence of internal and external sources having a bearing on corporate governance. This shall be helpful in ensuring that the Board’s decisions are taken in the best interests of Licensee.

3.3.1.8 The Board shall recruit and develop talented and capable senior management who will enjoy the Board’s confidence.

3.3.1.9 It is of crucial importance for the Board to have in place a well thought-out management succession plan.

3.3.1.10 It is the responsibility of the Board to approve and monitor a risk management framework that reflects best practices and implements the risk management strategies approved by the Board, across all business activities and operations.

3.3.2 Supervision of Major Initiatives

3.3.2.1 The Board shall maintain supervision of major strategic and business initiatives which may impact the financial condition or performance of the Licensee.

3.3.3 Overseeing Policy Implementation

3.3.3.1 The Board shall stipulate and review periodically implementation reports on its policies submitted by the management and decide on amendments, modifications, corrective measures, guidelines, etc., inter alia, in the light of review of findings. The Board should be interested not only in an absolute return to the shareholders
but also in the Licensee’s growth and sustained quality earnings over the long term, resulting from sound fundamentals of good governance. These fundamentals include (but are not limited to): coordinated balance sheet management, maintenance of quality assets, well-controlled expenses and sound and appropriate treasury and risk management strategies based on intimate knowledge of markets served.

3.3.3.2 The Board shall recruit the Head of Internal Audit and make him responsible to deliver his maiden presentation to the Board on the findings of the audit soon after its completion. It is necessary to stipulate that audit reports are submitted to the Board and simultaneously endorsed to the management. Similarly, the responses and/or compliance from the management shall be forwarded to the Head of Internal Audit with simultaneous endorsement to the Board. The Board shall put in place an appropriate internal control system covering both financial and non-financial controls.

3.3.3.3 The Board shall stipulate that external audit reports are submitted to it directly and not through the Chief Executive Officer/General Manager (CEO/GM). The Board shall maintain direct and ongoing communication with external auditors.

3.3.3.4 Members of the Board shall not partake in the implementation of its policy decisions except as provided for in the delegation approved by the full Board in specific areas for specific purposes subject to subsequent advice to the Central Bank. While the Board depends on the management’s expertise to run the Licensee’s daily operations, it remains ultimately responsible for the Licensee’s monitoring. The Board is expected to exercise utmost caution to ensure that while being the bearer of ultimate responsibility for monitoring operations, it does not overstep in the jurisdiction of the management constricting its freedom of operation.

3.3.4 Ensuring Compliance with Laws and Regulations

3.3.4.1 The Board shall establish a compliance function that will develop necessary systems and controls, assess the impact of new laws and regulations on the Licensee’s operations and procedures and conduct periodic compliance reviews.

3.3.5 Nurturing Proper and Ethical Behaviour

3.3.5.1 The Board should nurture an ethical culture in the Licensee so as to make sure that reputational and legal risks are minimized.

3.3.6 Transparency and Integrity in Stakeholder Reporting
3.3.6.1 The Board shall ensure that corporate governance is practiced transparently with accurate and relevant information being reported to stakeholders in a timely manner.

3.4 Role and Responsibility of the Management

3.4.1 Rendering Assistance in Policy Formulation

3.4.1.1 Management shall be accountable to the Board for responding adequately and appropriately to the call for presenting contributions towards policy formulation based on field level operational experiences, perceptions of the markets and industry. It is the responsibility of the management to volunteer to make timely submissions to the Board for policy initiatives in strategic, emergent and profit enhancing and cost saving areas of operations and also on matters having or likely to have material impact on the Licensee.

3.4.2 Responsibility for Implementation

3.4.2.1 Management is responsible for implementation of the Banking Law 2000 and Regulations and Circulars issued by the Central Bank and the other relevant regulatory authorities within the Sultanate of Oman.

3.4.2.2 Management will have the responsibility for implementation of the Board-approved policies by putting in place procedures, internal controls, risk and performance measurement methodologies, management information systems and reports to support the activities concerned.

3.4.3 Responsibility For Transmitting Correct and Timely Signals

3.4.3.1 Management is responsible for bringing to the Board’s attention objective feedback on implementation experiences including suggestions for amendments to and/or fine-tuning of the Board-approved extant policies.

3.4.4 Making Professionalism and Expertise Manifest

3.4.4.1 Management shall manifest its professionalism in running the Licensee most efficiently and in accordance with the Board-approved policies. It shall harness the required expertise for achieving the corporate goals. In doing so, it shall not overstep in the jurisdiction of the Board of Directors, by usurping prerogatives of the Board in the matter of fine-tuning policy perspectives.

3.4.5 Nurturing Proper and Ethical Behaviour

3.4.5.1 Senior Management must establish and maintain through word and action an appropriate code of business conduct drawn from value based professional
culture. It shall ensure that the code and the value based professional culture are practiced by the entire organization.

3.4.6 Responsibility for Complete and Authentic Reporting to the Board

3.4.6.1 While Management is entitled to operate with full professional freedom within the Board-delegated authority, it has an obligation to observe and display transparency and authenticity in its complete and comprehensive reporting on the Licensee’s operations.

3.4.7 Responsibility for Corporate Image

3.4.7.1 Management has direct responsibility for creating and maintaining fair corporate image of the Licensee. The responsibility assumes added significance in the context of the management’s proximity with the clientele and having been charged with the responsibility for the operations of Licensee.

3.5 Committees of the Board - Delegation of Powers

3.5.1 The Board is competent to set up committees considered necessary to enhance the corporate objectives, adhering to the following:

3.5.1.1 Committees shall comprise some of the members of the Board with appropriate experience, expertise and initiative to discharge responsibility for deciding on:

3.5.1.1.1 Specific policy matters demanding in-depth study, time consuming deliberations, focused attention, interactive consideration of the issues, etc.;

3.5.1.1.2 Micro matters of business beyond the powers delegated to the management but considered less important to receive the full Board’s attention and time;

3.5.1.1.3 Any other matter considered appropriate for delegation.

3.5.1.2 For all the Committees of the Board there should be a self-explanatory and comprehensive Terms of Reference, specifying purpose, membership, delegation, powers, frequency of meetings, tenure, duties, responsibility, authority, accountability, etc.

3.5.1.3 Committees established by the Board on which individuals other than Board members are nominated shall not enjoy the powers of the Board and shall be advisory in nature as their purpose is to afford a focused attention to the tasks assigned to them and facilitate Board decisions thereon.

3.5.1.4 Minutes of every meeting of the Board Committees shall be included in the agenda for the first full Board meeting scheduled to be held after the Committees’ meeting. Reporting of the minutes of the Committee meetings could be “for
approval”, “for ratification”, “for information” etc. as is appropriate with reference to powers delegated to the Committee.

3.6 **Chief Executive Officer / General Manager**

3.6.1 The Chief Executive Officer (“CEO”) / General Manager (“GM”) is accountable for proposing policies, evolving and adopting implementation strategies in respect of the Board-approved policies and initiating measures for profit growth in the short term without sacrificing the medium and long term profit and net worth enhancement potential. The CEO/GM is expected to provide leadership by establishing style and spirit that enhances the image and reputation of the Licensee.

3.7 **Committees of Management - Delegation of Powers**

3.7.1 The CEO/GM is empowered to set Management Committees should he consider it necessary in the business interest of the Licensee and generally to enhance efficacy of operations.

3.7.2 For all the Management Committees there should be self-explanatory and comprehensive Terms of Reference specifying purpose, tenure, tasks, duties, membership, delegations, powers, meetings, responsibility, authority, accountability, etc.

3.7.3 It is necessary that minutes of each meeting are submitted to the CEO/GM immediately after the meeting. Reporting of the minutes of the Management Committees’ meeting could be “for approval”, “for ratification” or “for information”, etc. as is appropriate with reference to powers delegated to the Committees.

3.7.4 Overlap in the Terms of Reference of various Management Committees should be strictly avoided.

3.8 **Deviations from the Stipulated Demarcation Procedures**

3.8.1 In the event of the CEO/GM or any other key management position falling vacant without adequate and proper notice or any other emergent situation in the assessment of the Board of Directors requiring deviation from the principles of demarcation between the role and responsibility of the Board of Directors and that of the management, an immediate reference shall be made to the Central Bank, under acknowledgment, detailing, inter alia, the following:
3.8.1.1 The exact nature of deviation with specific reference to the principle(s) vide provisions of Articles 4.4 to 4.7 of this Title;

3.8.1.2 The duration for which the proposed deviation would be resorted to;

3.8.1.3 Reason(s) in support of the proposed deviation;

3.8.1.4 Modalities of protecting the rationale of the principle(s) during the period of deviation;

3.8.1.5 Proposed plan to have in place normal arrangements avoiding need for deviation sought;

3.8.1.6 Any other relevant information considered necessary.

3.8.2 In any emergent situation Licensees may resort to deviation and make a post-facto reference to the Central Bank, under acknowledgment and unless directed to the contrary within 15 days from the date of reference, the deviation resorted to may continue. However, the Central Bank reserves the right to direct the Licensee to return to normality any time during the period of the deviation. Notwithstanding the above referred provision, the Central Bank will appreciate Licensees obtaining its prior permission as far as possible before a deviation is resorted to. The guiding factor shall be the corporate interest of the Licensees.

3.9 Prohibition on Holding of Multiple Directorships

3.9.1 No domestically incorporated Licensee shall appoint to its Board of Directors any person who is already a member of the Board of Directors of another Licensee.

3.9.2 The above prohibition on directorships applies also in the case of persons appointed to the Licensees’ Boards on the basis of proxies issued by the shareholders owning significant equity stake in Licensees.

3.9.3 A person who is a director of a Licensee is not eligible for / entitled to be a director in another Licensee and consequently there is no question of his appointing somebody else as proxy in the latter.

3.9.4 The Central Bank has also taken into consideration the objective underlying the legal prohibition of avoiding conflict of responsibility as stated above.

3.9.5 All instances of unauthorized deviations from the principles and procedures laid down via Articles 4.4. to 4.7 of this Title noticed by the Central Bank or brought to its notice will be communicated to the concerned Licensees for their clarifications/explanations to be submitted within a time frame specified by the Central Bank.
3.9.6 After reviewing the deviations in the light of the clarifications / explanations furnished by the Licensees, the Central Bank may convene a meeting with the Board of Directors. The Licensees shall implement the decision taken by the Central Bank in regard to such deviations.

3.9.7 Licensees incorporated within the Sultanate of Oman are required to note that any conflict of interest reported to the Central Bank from any source shall be settled in the light of the said principles.

3.9.8 Notwithstanding the above, members of the Board and management of the Licensees shall be liable to be displaced as per the regulations of the Banking Law 2000 in the event of non-observance of the provisions of this Title in letter and spirit.
4. Miscellaneous

4.1 Importance of the Compliance Function

4.1.1 Basle Committee on Banking Supervision (BCBS) which is engaged in developing minimum standards and best practices in various banking functions, defines the compliance function as “an independent function that identifies, assesses, advises on, monitors and reports on the bank’s compliance risk, that is the risk of legal or regulatory sanctions, financial loss or loss to reputation a bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice”.

4.1.2 Losses and penalties resulting from non-compliance can be severe ranging from withdrawal of the license to change of the Board and management, stringent penalties and other actions. The immediate fall-out of such supervisory actions would be loss of depositor trust and the confidence of investors and customers. Such loss of reputation may end up in a run on the Licensee by depositors and investors which could jeopardise the survival of a Licensee and may adversely impact the whole financial system.

4.1.3 The Central Bank in view of such circumstances sees the existence of the compliance function as an integral part of sound management framework in banking and finance and a tool for moderating risks.

4.1.4 The primary function of compliance set-up is to work towards constantly keeping reputation risk at “zero” level and maintaining public trust and confidence in the Licensee at the entity level and the financial system at the systematic level. One of the important objectives of the function is to ensure a high degree of adherence to laws and regulations.

4.1.5 Licensees will be able to manage compliance risk more effectively if they have a comprehensive compliance function in place. Further, while most of the regulations require ongoing adherence, experience shows that actual compliance is limited to a one time rectification of the issues/cases pointed out without implementing any long lasting measures to ensure on-going compliance and mitigate the compliance risk.

4.2 Compliance Function for the Licensees

4.2.1 The overriding consideration for the Central Bank is that Licensees must regard compliance as a core risk management activity within the organization.
4.2.2 Compliance starts at the top and is observed to be most effective in a corporate culture that emphasises standards of honesty and integrity and in which the Board and senior management lead by example.

4.2.3 The Board shall be responsible for appointing a Head of Compliance (HOC) / Compliance Officer (CO), establishing and approving a Compliance Policy delineating the principles and processes for identifying and managing compliance risks in the Licensee.

4.2.4 The senior management is responsible for working out compliance policy and processes, manuals, defining and clearly specifying the role, responsibilities and rights of the function, duties of other departments / units and relationship of compliance function with them in order to have a clear understanding of the roles of the job. The function needs to have direct access to all the files and information. The function should have the right to conduct investigations and report directly to appropriate authorities on any breaches of the compliance policy and processes.

4.2.5 While it is the line management that executes the compliance actions, senior management is responsible for ensuring that the line management does so. Senior management is also responsible for ensuring that the policy and processes are observed both in letter and spirit and that appropriate remedial or disciplinary action is taken for any breaches.

4.2.6 Compliance function needs to have a formal status approved by the Board to give it appropriate standing authority and independence. The compliance function should directly report to the Board or to a committee of the Board. In view of this HoC/CO may report to the Board Risk Committee for the limited purpose of compliance risk. It would be beneficial for the Board or the Committee to meet with the HoC/CO at least bi-annually or at shorter intervals. In the case of entities without a Board / Board committees (e.g. foreign bank branches) reporting should be to the Head of the functional line and in case of territorial reporting structure, to the overall Head of Territory. The objective here is that the HoC/CO functions stand alone as ‘four eyes’. HoC/CO reporting to senior management should be confined to furnishing the non-compliant issues that needs to be acted upon and monitoring progress.

4.2.7 The compliance function may be organized by the Licensees in one of the following ways depending upon their size, nature and complexity of operations and organisational structure:
4.2.7.1 Having a number of COs placed in core departments / units with each CO addressing compliance issues in their respective department/unit and reporting to HoC of the Licensee. The individual CO would not be under the control of the concerned department / unit for which the individual is responsible. The COs report only to the HoC. The Central Bank shall have dealings only with the HoC.

4.2.7.2 The Licensee can have a HoC/CO with adequate staff attending exclusively to the compliance function without being assigned any other tasks.

4.2.7.3 The Licensee can have a HoC/CO who not only attends to compliance issues but other assigned portfolios. This is appropriate for very small institutions. It should however be ensured that the other tasks assigned do not lead to conflict of interest situations e.g. HoC/CO should not be assigned business / operational line functions.

4.2.7.4 The compliance function of Licensees which are internationally active either through the establishment of foreign branches or having significant investments in foreign joint ventures/associates etc. should formulate a comprehensive compliance policy / strategy for such overseas entities by reckoning the applicable laws and regulations of the host country. It should be ensured that compliance responsibilities specific to each jurisdiction are carried out by individuals having appropriate local knowledge and expertise, with oversight from the HoC/CO.

4.2.7.5 The compliance functionaries need to possess necessary qualifications, experience in banking and other financial sector related laws, regulations and compliance, qualitative and quantitative analytical abilities, professional and personal qualities such as integrity, neutrality, independent judgment and good communication skills. It must be ensured that “fit & proper” criteria are fulfilled while appointing the HoC/CO.

4.2.7.6 The HoC/CO would also need to be a part of senior management in order to lend stature and authority. The function should be independent, sufficiently resourced and not to be assessed as a profit center. In view of the Internal Audit (IA) function being required to audit the compliance function, it is axiomatic that the IA should not be assigned the HoC/CO role. With regard to other functionaries, the objective being avoidance of conflict of interest, such functionaries who are not responsible for operational business lines, such as legal or financial control for instance, could be designated as HoC/CO.

4.2.7.7 Compliance function shall address on an ongoing basis various aspects of compliance; e.g. compliance with applicable laws and regulations of the Sultanate.
i.e. Banking Law 2000, Money Laundering Law, regulations of the Central Bank and the CMA, regulations in case of cross border operations, international best practices, conventions collated by international bodies such as the Basel Committee, Financial Action Task Force (FATF), etc.

4.2.7.8 The broad responsibilities that are to be attended to by the HoC/CO shall be:

4.2.7.8.1 Identifying and assessing compliance risk in all business activities including in all new products and services;

4.2.7.8.2 Advising on compliance policy, processes, rules and standards;

4.2.7.8.3 Assessing the impact of new laws, regulations and guidelines and work out adequate processes for compliance;

4.2.7.8.4 Implementing and reviewing policies and processes including follow-up and compliance for the examination and other reports of the Central Bank;

4.2.7.8.5 Guiding the staff on implementation of compliance policies and processes;

4.2.7.8.6 Assessing whether internal processes are appropriate / adequate;

4.2.7.8.7 Prompt reporting on the breaches and effectively following up on any identified deficiencies;

4.2.7.8.8 Discharging specific statutory responsibilities (e.g. Money Laundering Reporting Officer or MLRO);

4.2.7.8.9 Liaising with relevant external bodies and furnishing regulatory compliance reports;

4.2.7.8.10 Sample compliance testing to validate the certification by the departments / units.

4.2.7.9 In sum HoC/CO would be the nodal point for all compliance matters and is to bring about a compliance culture across the Licensee encompassing all the jurisdictions and businesses in which the Licensee operates.

4.2.7.10 Complying with various laws and regulations primarily is the responsibility of the concerned department/unit. HoC/CO should indicate the laws / regulations not complied with either in full or in part and the reasons for non-compliance.

4.2.7.11 HoC/CO should review and submit half yearly reports to the Board or a Committee of the Board on the compliance status at various departments/units showing compliance with all the law, regulations, best practices, etc. particularly highlighting and detailing breaches. A status report on the action taken on the HoC/CO’s review on the compliance policy and its implementation to be submitted by the senior management should also be annexed. In case the HoC/CO
comes across significant breaches of laws, rules, regulations or other compliance requirements, such transgressions should immediately be reported to concerned authorities without waiting for the periodical report submission date.

4.2.7.12 On the basis of the compliance reports received from the departments / units HoC/CO should furnish a half yearly certificate of ongoing compliance with the provisions of the Banking Law 2000 and other banking and finance related laws, regulations and instructions issued by the Central Bank or the government, in addition to the guidelines of bodies such as Basel Committee in so far as they pertain to banking and finance business and any other compliance requirements to the Central Bank’s Banking Examination Department (BED).

4.2.7.13 Along with this certificate a copy of the status report submitted to the Board and its comments should be attached. The format of the Certificate will be prescribed by the Central Bank to ensure consistency and minimum coverage. The Central Bank may also call for such certificates at shorter intervals if warranted.

4.2.7.14 HoC/CO is also expected to confirm compliance by performing sufficient and representative sample compliance testing for validating the certificates furnished by departments/units. The reporting by MLRO under Anti-Money Laundering Laws and procedures will continue.

4.2.7.15 Compliance function should be subject to periodic independent review by the Internal Audit as part of its risk assessment methodology, especially in ensuring the veracity of the compliance reports furnished to the HoC/CO by the departments / units. HoC/CO needs to coordinate with IA in this regard. While HoC/CO’s responsibility is to assess the compliance risk and ensure compliance with laws, rules and regulations, the IA’s responsibility is towards verification of actual on ground compliance.

4.3 Corporate Governance Compliance Disclosure

4.3.1 Disclosure by the Licensee of compliance to the Central Bank in the annual report is not mandatory while such disclosure in the case of CMA’s code is mandatory.

4.3.2 This disclosure is on a voluntary basis with the condition that whichever Licensee decides to do so, it must apply for prior permission from the Central Bank.

4.3.3 The Licensee is required by the Central Bank to forward the text of the compliance disclosure proposed.
4.4 Operational Controls

4.4.1 Licensees are required to be vigilant about operational standards and controls in maintaining compliance with the Central Bank rules and guidelines. These include the following:

4.4.1.1 Awareness among the Licensees’ staff about the importance of compliance must be high. Mostly violations and non-compliance are attributed to front level staff. Training of staff at the entry level is crucial to enhancing the efficiency of operations.

4.4.1.2 Dual control and authorization for material transactions should be properly implemented in practice, although they are documented in the policy and procedure manuals of the Licensees.

4.4.1.3 Management should provide sufficient oversight so that any fraudulent or dummy entries are captured early on. At the managerial, control and audit levels adequate supervision is required so as not to have any weak areas going undetected.

4.4.1.4 The Licensees must allocate and demarcate clear lines of responsibility for all the various functions involved in operational controls.

4.5 Customer Due Diligence for Banks

4.5.1.1 Know Your Customer (“KYC”) procedure is an essential part of corporate governance and Licensees are required to maintain high standards of KYC to protect them from reputational, operational, legal and concentration risks.

4.5.1.2 Licensees are advised to follow international best practices as stipulated by the Basel Committee on Banking Supervision on additional requirements to monitor KYC.

4.5.1.3 Licensees should formulate a customer acceptance policy; tiered customer identification program that involves more extensive due diligence for higher risk accounts.

4.5.1.4 Below are some relevant guidelines extracted from the Basel Committee for Licensees to follow so as to enhance KYC standards in their organization:

4.5.1.4.1 KYC procedures have a particular relevance to the safety and soundness of Licensee in that they help in protecting the Licensee’s reputation and thereby reduce reputational risk;

4.5.1.4.2 Licensees should realize that an essential element of KYC is to know the person / entity that maintains the account and the beneficiaries of this account;
4.5.1.4.3 Licensees must in the case of funds that are commingled ensure who the original beneficial owners are;

4.5.1.4.4 Ongoing employee training programs should be implemented to enhance KYC standards within the organization.\(^5\)

4.6 **Licensees’ Privacy Policy for Use of Customer Information**

4.6.1 Licensees can use customer information subject to certain conditions laid down by the Central Bank. These include:

4.6.1.1 Does the stipulated financing documentation used by the Licensee include a waiver clause to the effect that any disclosure of customer information by the Licensee or its officers in the normal course of business cannot be interpreted as a breach of confidentiality and no damages could be claimed?

4.6.1.2 Has the Licensee evolved a privacy policy regarding use of customer information? If it has, it must produce the proof thereof to the Central Bank. If not, such a policy must be put in place immediately.

4.6.2 The Licensee must establish internal accountability standards specifying responsibility for managing customer information as required by the Central Bank.

4.6.3 The Licensee must declare if it has been sued by any of its customers for breach of confidentiality during the last five years. And if so, the Central Bank will require this to be documented and shared with its officers.\(^6\)

4.7 **Connected Financing and Transactions**

4.7.1 As a matter of general rule, Licensees shall ensure that no counter-party to a financial transaction is a party to the decision or decision-making process and that decisions are taken, as permitted by applicable provisions, by authorized non-interested functionaries, under appropriately structured delegated authority system and at arms’ length in such a way that there shall be no scope for abuse or doubt of good faith.\(^7\)

4.7.2 All financial decisions related to credit will go through check and control process of two or more, as all banking transactions generally should, and there shall be clear demarcation of authorities with provision for decisions to be reported by the approving functionary to a higher authority for post facto confirmation with reference, in particular, to fulfilment of laid down principles, policies, rules and procedures. Possible exceptions are a few operational delegations for the sake of
expediency and extraordinary cases (like those under staff welfare schemes) and, in those cases too, there should be adherence to best practices and organizational interests, and appropriately structured and conditional delegation, reporting and overseeing.

4.7.3 Licensees shall maintain absolute transparency in all transactions. Self-explanatory records of processing and approvals should be maintained and made available to the auditors and the Central Bank, when required.

4.7.4 The procedural manuals should incorporate details of the approval and reporting responsibilities and processes. It is imperative for the Board of Directors / management to ensure adherence, validation and assurances through the Audit Committee, internal and external auditors and other mechanisms, as appropriate to particular counter-parties.

4.7.5 The diligence, sought to be emphasized herein, shall cover but not be limited to credit (not only approval process but also material specifics like the basis of assessment, amount of financing, rate of profit and other terms, collaterals, mid-term appraisals, timely remedial actions, risk classification, provisioning, write off, reporting, etc.), deposits/investment accounts (rate of profit and other terms and linkages), other fund-based transactions, foreign exchange transactions and non-fund based transactions.

4.7.6 Nothing shall dilute the rigours to be followed in adhering to the approval and reporting stipulations mentioned in the code of Corporate Governance on related party transactions in the ordinary course of business and otherwise.
5. Attachment

5.1 Example Report of Shari’a Supervisory Board

In the name of Allah, The Beneficent, The Merciful

To the Shareholders of The Example Licensee

Assalam Alaikum Wa Rahrnat Allah Wa Barakatuh

In compliance with the letter of appointment, we are required to submit the following report:

We have reviewed the principles and the contracts relating to the transactions and applications introduced by the Example Licensee during the period ended. We have also conducted our review to form an opinion as to whether the Example Licensee has complied with Shari’a principles and also with the specific Fatawa, rulings and guidelines issued by us.

The Example Licensee’s management is responsible for ensuring that the Example Licensee conducts its business in accordance with Shari’a principles. It is our responsibility to form an independent opinion, based on our review of the operations of the Example Licensee, and to report to you.

We conducted our review which included examining, on a test basis, of each type of transaction, the relevant documentation and procedures adopted by the Example Licensee.

We planned and performed our review so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Example Licensee has not violated Shari’a principles.

In our opinion:

a) the contracts, transactions and dealings entered into by the Example Licensee during the year ended 20XX that we have reviewed are in compliance with Shari’a principles;

b) the allocation of profit and charging of losses relating to investment accounts conform to the basis that had been approved by us in accordance with Shari’a principles;

(Where appropriate, the opinion paragraph shall also include the following matters:)

- all earnings that have been realized from sources or by means prohibited by Shari’a principles have been disposed of to charitable causes, and
- the calculation of Zakah is in compliance with Shari’a principles.

We have identified the following areas where we believe there is room for further improvement by the management of the Example Licensee in order to follow truly the letter and spirit of the Shari’a and to enhance the public’s confidence in Islamic banking in general and the Example Licensee in particular:

a) …

b) …
c) …

We beg Allah the Almighty to grant us all the success and straight-forwardness.

Wassalam Alaikum Wa Rahmat Allah Wa Barakatuh

(Names and signatures of the members of the Shari'a Supervisory Board)

Place and Date

In case the SSB detects major violations of Shari’a principles by the Example Licensee, the opinion paragraph may be replaced with the following:

a) Some of the contracts, transactions and dealings entered into by the Example Licensee during the year ended 20XX that we have reviewed are not in compliance with Shari’a principles. Those are listed below:
   - Contract X; brief summary, listing of Shari’a violation, rectification or resolution
   - Transaction Y; brief summary, listing of Shari’a violation, rectification or resolution
   - Process Z; brief summary, listing of Shari’a violation, rectification or resolution

b) The allocation of profit and charging of losses relating to investment accounts does not conform to the basis that had been approved by us in accordance with Shari’a principles:
   - Explanation of the issue
   - Resolution or rectification

On account of the above Shari’a violations we are not in a position to verify the Shari’a compliance of the Example Licensee’s operations.
5.2 Operational Procedures for Shari’a Supervisory Board

5.2.1 Presentation of Request for Decisions on Shari’a related Matters

5.2.1.1 All proposal papers submitted to the SSB by the management of the Licensee must clearly state the purpose of the paper and be presented to the SSB with sufficient and adequate details to facilitate evaluation of the proposals.

5.2.1.2 All papers for presentation shall be submitted to the Internal Shari’a Reviewer for onwards distribution to the members of the SSB not later than one week prior to the SSB meeting. Any paper submitted after the cut-off time shall be presented to the SSB only upon approval of the Chairman of the SSB.

5.2.2 Appointment of the Chairman of SSB

5.2.2.1 One of the members of the SSB with Shari’a background and qualifications shall be elected as its Chairman. The Chairmanship should preferably be on a rotation basis, such as whenever there is a reappointment of the SSB.

5.2.2.2 In the event that the Chairman is unable to attend a meeting, the members shall elect one of the members present to become the alternate Chairman to preside over the meeting.

5.2.3 Secretariat of the SSB

5.2.3.1 The Internal Shari’a Reviewer shall act as the Secretary to the SSB. For any secretarial functions the Shari’a compliance unit shall provide its services.

5.2.4 Frequency of Meetings

5.2.4.1 The SSB shall meet regularly (but not less than four times a year) to carry out periodic reviews to monitor Shari’a compliance of the operations of the Licensee. However, as and when necessary, the SSB can hold a meeting if the Licensee urgently requires its advice and opinion on Shari’a related matters.

5.2.4.2 SSB members must attend at least 75% of the meetings in any given year, preferably in person in the normal course of business. However, in case of unusual circumstances they may also choose to attend through conference call or video conference.

5.2.4.3 The number of SSB meetings held in a year and the attendance of each SSB member shall be disclosed in the Licensee’s annual report.

5.2.4.4 The SSB should also plan and arrange to meet with the Board of Directors of the Licensee at least once a year to discuss issues of common interest. The SSB shall document its observations, concerns and suggestions for the Board.
5.2.5 Quorum for the Meetings and Decision Making

5.2.5.1 The SSB should determine a quorum for its meetings as appropriate, based on the majority of SSB members. For example, a SSB comprising five members may set its quorum as three.

5.2.5.2 The quorum set should ensure that the Shari’a legitimacy of the decisions made by the SSB is not diluted. For any SSB decision to be effective it needs to be taken by consensus or by majority of Shari’a scholars. In case of the latter, Shari’a scholars must form majority of the members present and support the decision. No decision can be taken if at least two Shari’a scholars do not support it (or a higher number in case of larger SSBs).

5.2.5.3 SSB members who are unable to attend but have valid reasons shall be recorded as “absent with apology”, while absenteeism without valid reason shall be treated as “absent without apology”, and the minutes shall be recorded as such.

5.2.6 Attendance of Senior Management

5.2.6.1 Senior management of the Licensee may attend the SSB meeting to represent the management’s views on issues discussed in the meeting, but shall carry no voting or veto rights.

5.2.6.2 The Chairman, and in his absence the alternate Chairman, is empowered to invite any relevant senior management personnel to sit in SSB meetings.

5.2.7 Minutes of Meetings

5.2.7.1 The Secretary of the SSB shall be responsible for recording the minutes of SSB meetings. Any differences of opinion or dissenting opinions among members of the SSB shall be referred to in the minutes.

5.2.7.2 All minutes of the SSB meetings shall be submitted to the relevant internal control functions within the Licensee for their notification and further action.

5.2.7.3 All minutes must be properly archived by the Secretary of the SSB for future reference. Upon request, they shall be made available to the internal auditor, external auditor and examiner from the Central Bank.
### 5.3 Statement of Sources and Uses of Charity Fund

<table>
<thead>
<tr>
<th></th>
<th>This year</th>
<th>Previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Additions during the year</td>
<td>XXX</td>
<td>XXX</td>
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<td><em>(specify by major categories)</em></td>
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</tr>
<tr>
<td>Payments / utilization during the year</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><em>(specify by major categories)</em></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing balance</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
5.4 Sample of Performance Assessment for the SSB

5.4.1 The assessment process shall be objective and related to the accountability of the SSB. It is important to ensure that it is transparent so that it is not misused or abused by the Board of Directors or senior management of the Licensee to force their will on the SSB or to compromise its independence.  

5.4.2 Collective Assessments

5.4.2.1 Did the SSB demonstrate effective organizational accountability?
5.4.2.2 Did the SSB communicate effectively with other organs of governance, including the Board, management and auditors?
5.4.2.3 Did the SSB properly identify and evaluate the organization’s exposure to Shari’a non-compliance risk and reputational risk, and effectively communicate that risk information to appropriate bodies in the organization?
5.4.2.4 Did the SSB promote appropriate ethics and values within the organization?
5.4.2.5 Did the SSB promote continuous improvement of the organization’s Shari’a control processes?

5.4.3 Individual Assessments

5.4.3.1 Did each member of the SSB attend at least 75% of the SSB meetings held during the past 12 months either in person or through video / conference call?
5.4.3.2 Did each member of the SSB contribute, to the best of his ability, in enriching the discussion and deliberation of the issues raised in Shari’a Board meetings?
5.4.3.3 Did each member of the SSB demonstrate integrity and honesty?
5.4.3.4 Did each member of the SSB strive for continuous self improvement?
5.4.3.5 Did each member of the SSB accept responsibility with due care and diligence?
5.4.3.6 Did each member of the SSB strive to be sensitive to cultural differences?
5.4.3.7 Did each member of the SSB strive to be observant / aware of contextual factors before coming to a decision?
5.4.3.8 Did each member of the SSB exercise rational and logical reasoning?
5.4.3.9 Did each member of the SSB demonstrate willingness to learn from others?
5.4.3.10 Did each member of the SSB strive to be inquisitive (capable of asking intelligent and relevant questions)?
1 BM 932
2 BM 957
3 BDD/CBS/CB/2009/1593
4 BM 921
5 BDD/CBS/CB/2009/5545
6 BED/2003/BK-UP-328/Banks & FIs/457
7 BM 989
8 IFSB’s Guiding Principles on Shari’a Governance Systems for Institutions Offering Islamic Financial Services, December 2009.
9 This is not part of the IFSB Guiding Principles and has been added separately.
TITLE 3: ACCOUNTING STANDARDS AND AUDITOR REPORTS

Islamic Banking Regulatory Framework
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1. **Introduction**

1.1 **Scope of Coverage**

1.1.1 The Accounting Standards and Auditor Reports Title (“the Title”) applies to both full-fledged domestic Islamic Banks, Islamic Windows of domestic Conventional Banks and Islamic Branches in Oman of Foreign Banks that are regulated and supervised by the Central Bank of Oman (“Central Bank”).

1.2 **Applicable Accounting Standards**

1.2.1 Full-fledged Islamic banks in Oman shall follow Financial Accounting Standards (“FAS”) issued by the Accounting and Auditing Organization for Islamic Institutions (“AAOIFI”). In accordance with the requirements of AAOIFI, for matters where no AAOIFI standards exist, the Licensees can use the relevant International Financial Reporting Standards (“IFRS”).

1.2.2 Islamic Windows / Islamic branches of foreign banks in Oman shall follow AAOIFI’s accounting and auditing standards. The parent conventional bank shall consolidate the financial statements according to the IFRS. Disclosures with regard to consolidation shall be covered in the Notes to Accounts.

1.2.3 *Please refer to Attachment 9.4 for major differences between AAOIFI and IFRS standards.*

1.3 **Definition of an External Auditor**

1.3.1 An external auditor is an independent audit professional who conducts an audit according to specific rules and standards.

1.3.2 The external audit team includes the partners, directors, managers and team members responsible for the audit of a Licensee.

1.4 **Functions of an External Auditor**

1.4.1 An external auditor conducts an audit of a Licensee’s accounts in accordance with auditing standards for Islamic financial institutions issued by AAOIFI and International Standards on Auditing and Assurance issued by IAASB where applicable;
1.4.2 An external auditor produces and submits to the Central Bank a report on the audited accounts which states:

1.4.2.1 Whether, in the external auditor’s opinion, the accounts have been properly prepared in accordance with the requirements imposed by AAOIFI;

1.4.2.2 Whether the accounts present fairly in all material respects the financial position of the Licensee; and

1.4.2.3 Any other opinion related to the requirements of this Title.

1.4.3 An external auditor produces an audit report which states whether the external auditor has:

1.4.3.1 Audited the Licensee’s annual financial statements in accordance with the AAOIFI accounting standards;

1.4.3.2 Received all required information and explanations to prepare the report; and

1.4.3.3 Carried out any other procedures considered necessary as required by AAOIFI and the Central Bank.

1.4.4 The external auditor shall focus on examining the Licensees’ compliance with the provisions, regulations and prudential standards for supervision mandated by the Central Bank.¹

1.4.5 External auditors shall present their Shari’a examination report on the Licensee’s systems and controls with respect to Shari’a compliance to the Internal Shari’a Reviewer who may present it to the SSB.

1.4.6 External auditors appointed for the purpose of examining the Licensees’ systems and controls to verify compliance with Shari’a guidelines issued by the SSB shall report their findings to the Central Bank.

1.4.7 External Auditors shall, among others, validate disclosure compliance as stated in Title on Capital Adequacy.
2. Appointment / Dismissal of External Auditor

2.1 Appointment of External Auditor

2.1.1 Licensees shall only contract with the external auditor after receiving approval from the Central Bank. ¹

2.1.2 Domestic Licensees shall submit a list of external audit firms, in the order of their preference, for appointment as external auditors at least two months in advance of the proposed annual general meeting of the shareholders. ²

2.1.3 Foreign Licensees shall seek Central Bank clearance on the external auditor after obtaining approval from a competent authority in their home country. ³

2.1.4 The Central Bank has the right to call revised nominations, for cause. ⁴

2.1.5 The external audit firm nominated by a Licensee shall comply with the following conditions / qualifications criteria: ⁵

2.1.5.1 It should be registered with the Ministry of Commerce and Industry;

2.1.5.2 It should have audit experience of not less than five years;

2.1.5.3 It should have a minimum of five qualified professionals in auditing;

2.1.5.4 It should have a good understanding and competence in the audit of Islamic Banks / Islamic Windows and have not been barred or subjected to any penalty for professional or audit improprieties by the government or any of its units and public authorities or institutions or any judicial or professional authority; and

2.1.5.5 It should not have interest in the Licensee nominating it as external auditor, whether as a member of the board of directors, shareholders or employees, for the last two years.

2.1.6 The following are examples of factors that the Central Bank may consider when deciding on the appointment of an external auditor:

2.1.6.1 Proficiency and reputation of the external auditor;

2.1.6.2 Resources of the external auditor relative to the size and complexity of the Licensee; and

2.1.6.3 External auditor’s compliance with applicable laws and regulations.

2.1.7 Approval of the Central Bank does not in any way limit shareholders’ rights to reject the external auditor.
2.1.8 Licensees shall submit to the Central Bank brief details about the qualifications and experience of the partners in the external audit firm and the number of auditors with professional accounting / auditing qualifications.

2.1.9 Licensees shall submit to the Central Bank full details about the competence, professional experiences and technical arrangements of the external auditor. \(^6\)

2.1.10 The responsibility for obtaining true and fair audit reports on the financial statements shall be with the Licensees. The Central Bank shall not be held responsible for failure or negligence in discharging the assigned duties and statutory responsibilities by the external auditor, whose appointment has been cleared by the Central Bank. \(^7\)

2.2 **Removal or Resignation of External Auditor**

2.2.1 Licensees shall notify the Central Bank in the following cases:

2.2.1.1 If they intend to remove their external auditor; and

2.2.1.2 If their external auditor intends to resign.

2.2.2 Licensees shall inform the Central Bank in writing if they intend to remove their external auditor or if their external auditor intends to resign immediately setting out the reasons for the resignation or termination.

2.2.3 The Central Bank may terminate the contract between the external audit firm and the Licensee, by a decision for cause, when required in public interest. Such decision shall be communicated to the Licensee in writing. The Licensee shall advise the external audit firm of such decision, and shall implement the decision within a period of 30 days from the date of communication of the directive. \(^8\)

2.2.4 The Licensee shall engage another external audit firm as soon as reasonably practicable after a vacancy occurs which should be in compliance with the Central Bank’s requirements.
3. **External Auditor Requirements**

3.1 **External Auditor Rotation**

3.1.1 Licensees have the right to determine the duration of contracts with the external auditor provided that the same external audit firm shall not be appointed for more than four consecutive financial years. A minimum cooling off period of 2 years shall be enforced after the completion of the referred audit period.  

3.2 **External Auditor Independence**

3.2.1 The Licensee is responsible for taking necessary steps to ensure that the external auditor is independent of the Licensee’s activities.

3.2.2 For an external auditor to be considered independent of the Licensee, it must comply with the restrictions mentioned in 3.3.

3.2.3 The Licensee shall inform the Central Bank about any independence issues and take reasonable steps to remedy those issues.

3.2.4 The Central Bank may request the termination of the external auditor contract if issues are not resolved and independence has not been achieved within a reasonable timeframe.

3.3 **Licensee / External Auditor Restrictions**

3.3.1 Outsourcing the internal audit function

3.3.1.1 The Central Bank generally prohibits the Licensees from outsourcing their internal audit function to the same firm that acts as their external auditor. However, the Central Bank may allow short-term outsourcing of internal audit operations to the Licensee’s external auditor to meet unexpected urgent or short-term needs (for instance, on account of staff resignation or illness). Any such arrangement will normally be limited to a maximum period of one year and is subject to prior approval of the Central Bank.

3.3.2 Consultative services

3.3.2.1 Licensees are precluded from requiring their external auditors to provide them with consultative services, except for the services that are incidental to the audit function.  

3.3.3 Financing
3.3.3.1 No Licensee shall grant any credit accommodation to its own external audit firm or to any partners thereof or to any of the employees of such external audit firm.\textsuperscript{11}

3.3.4 Professional indemnity insurance/Takaful

3.3.4.1 Licensee shall not enter into any contracts of professional indemnity insurance/Takaful with their external auditor.

3.3.5 Other restrictions

3.3.5.1 The Central Bank prohibits the external auditor of a Licensee from the following:

3.3.5.1.1 Being the chairman or a member of the board of directors of the Licensee;

3.3.5.1.2 Holding any managerial position in the Licensee;

3.3.5.1.3 Buying any shares in the Licensee, or selling any owned shares, during the period of its audit;

3.3.5.1.4 Acting as a managing director, agent or representative of the Licensee; and

3.3.5.1.5 Taking up any administrative work in any of the Licensee’s departments, or supervising its accounts.

3.3.5.2 The external auditor must not be a relative (up to the second degree) of a person assuming management or accounting duties in any of the Licensee’s departments.

3.3.5.3 The above restrictions apply to foreign as well as domestic Licensees.

3.3.5.4 A partner, director or manager on the team auditing the Licensee may not be a member of the board of directors of or in a managerial position with the Licensee, for two years following the end of their involvement in the audit, without prior authorisation of the Central Bank.
4. **Audited Annual Financial Statements and Disclosure Requirements**

4.1 **Preparation and Submission of Financial Statements for Approval**

4.1.1 All Licensees are required to prepare and submit the statement of financial position and profit and loss account each financial year, in accordance with AAOIFI.\(^\text{12}\)

4.1.2 Licensees are required to prepare the financial statements as per the forms CBO / MDR / 1 to CBO / MDR / 5. (Refer to Attachment 9.1).

4.2 **Documents / Forms to be Submitted to the Central Bank**

4.2.1 Licensees are required to forward the following documents, duly signed by the authorized signatories of the Licensee and the external auditors, as per the formats prescribed, in a single lot:\(^\text{13}\)

4.2.1.1 Draft audited statement of financial position and profit & loss account, prepared in accordance with AAOIFI and IFRS where applicable, along with the notes on accounts;

4.2.1.2 External auditor’s interim report duly signed or initialled by the external auditors;

4.2.1.3 Management report issued by the external auditor;

4.2.1.4 Financial statements as per the forms CBO / MDR / 1 to CBO / MDR / 5 along with notes on minimum disclosure requirements;

4.2.1.5 Scheme of appropriation and distribution of profit for the year for domestic Licensees (Refer to Attachment 9.3.1) or details of profits proposed to be remitted to head office by foreign Licensees operating within the Sultanate (Refer to Attachment 9.3.2);

4.2.1.6 Schedule of classified financings with specific loss provisions and reserve profit held as at 31\(^\text{st}\) December (Refer to Attachment 9.3.3);

4.2.1.7 Schedule of account-wise movement in specific provisions and reserve profit for the year (Refer to Attachment 9.3.4);

4.2.1.8 Schedule of summary movement of provisions and reserve profit (Refer to Attachment 9.3.5);

4.2.1.9 Schedule on the adequacy of provisions (Refer to Attachment 9.3.6);

4.2.1.10 Schedule on restructured / rescheduled financings (Refer to Attachment 9.3.7);
4.2.1.11 Schedule on assets written-off (Refer to Attachment 9.3.8);
4.2.1.12 Schedule on own investments in shares (Refer to Attachment 9.3.9);
4.2.1.13 List of specially mentioned accounts as per Central Bank examiner (Refer to Attachment 9.3.10);
4.2.1.14 Format seeking confirmation of net worth or capital; and
4.2.1.15 Reserves for various regulatory limits indicating clear break-ups.

4.2.2 Domestically incorporated Licensees having branches overseas shall submit, in addition to the above, separate sets of the statement of financial position and profit & loss account in the forms CBO / MDR / 1 to CBO / MDR / 3 along with a summary of movement in provisions and reserve profit for their operations in Oman and each foreign country.  

4.2.3 Domestically incorporated Licensees having subsidiaries or joint ventures or other forms of organization, incorporated domestically or overseas, shall submit separate sets of statement of financial position and profit & loss account in the forms CBO / MDR / 1 to CBO / MDR / 3 for each such entity as well as a consolidated statement for the group as a whole, consolidating the accounts in accordance with AAOIFI and IFRS where applicable.

4.3 **Due Submission of Financial Statements for Approval**

4.3.1 The Licensees are required to submit the above documents along with draft audited financials, duly approved by the Board of Directors, for the approval of the Central Bank before presenting the same in the annual general meeting.

4.4 **Meeting with External Auditors**

4.4.1 After submitting the financial statements for approval, the Licensees are required to seek an appointment for the meeting of the external auditors with the Central Bank. Approval of financial statements is subject to the meeting with the external auditors.

4.5 **Publication of Financial Statements**

4.5.1 All Licensees shall publish by 31st March of the following year, after obtaining the approval from the Central Bank, a summarized statement of financial position and profit & loss account as outlined in Forms CBO / MDR / 1 and CBO / MDR / 3, respectively.
4.5.2 The summarized statement of financial position and profit & loss account shall be published in at least one Arabic language newspaper available in the Sultanate.

4.5.3 Licensees should ensure that the financial statements submitted to the Central Bank, statement of financial position and profit & loss account printed for the shareholders and other stakeholders and the published financial statements are consistent with each other.  

4.5.4 Micro level credit information cannot be disclosed without the consent of the Central Bank to any government agency or any person. Licensees may, however, submit the financial statements to Capital Market Authority (“CMA”) prior to the approval of the same by the Central Bank, subject to complying fully with the provisions issued by the Central Bank and with a disclosure that the financial statements are subject to the approval by the Central Bank. Further, Licensees should ensure that the audited financial statements are submitted simultaneously to the Central Bank for approval.

4.6 Disclosure Requirements

4.6.1 Detailed disclosure requirements have been provided in the Title on Capital Adequacy.

4.6.2 Licensees offering services through Islamic Windows shall declare that such services are in compliance with Shari’a requirements and are therefore required to meet the governance and other standards relevant to them as mandated by the Central Bank.

4.6.3 The following disclosures are necessary for an Islamic Window:

4.6.3.1 Whether or not the Islamic Window commingled funds related to Islamic financial business with funds relating to conventional financial business:

4.6.3.2 Sources and applications of funds mobilized and invested through the Islamic Window business and the sources of funds used to cover a deficit;

4.6.3.3 Any revenues prohibited by Shari’a and the disposition of any such revenues in accordance with the guidelines of the Shari’a Supervisory Board;

4.6.3.4 Any reserves deducted from the funds mobilized according to Shari’a, the purpose of such reserves and to whom the reserves shall revert in case the activities in respect of which the reserves were deducted have ceased; and

4.6.3.5 Percentage amount of funds relating to Islamic financial business in comparison with the percentage amount of funds relating to conventional financial business.
4.6.3.6 The Windows shall prepare separate financial statements based on AAOIFI standards. These financial statements shall be published as an appendix in the notes to the financial statements of the Licensees.
5. Reporting Requirements

5.1 Submission of Inspection / Audit Reports

5.1.1 All Licensees in Oman are advised to forward the following reports to the Central Bank:

5.1.1.1 Examination reports of the external auditors;
5.1.1.2 Inspection reports of regional offices / head offices (this refers to branches of foreign Licensees);
5.1.1.3 Evaluation reports of outside organisations such as the Capital Intelligence (if any); and
5.1.1.4 Reports of any other ad hoc inspections / audits which may include reports related to frauds, embezzlements, etc.

5.1.2 Licensees are also advised to ensure that the reports in languages other than Arabic or English are translated in either of the above two languages and then forwarded to the Central Bank together with a copy of the original report.

5.1.3 Licensees not submitting any of the above reports will be subject to penalties as specified by the Banking Law.

5.1.4 Licensees with operational branches outside the Sultanate that are supervised by the host country’s governing body must share the supervisor’s reports with the Central Bank.

5.1.5 Windows shall provide returns specified by the Central Bank for the purposes of monitoring compliance and consolidation.

5.2 Annual Report

5.2.1 Each Licensee shall submit to the Central Bank an annual report, audited by independent external auditors, pursuant to procedures established by the Central Bank at such times and in such form as maybe prescribed by the regulations of the Central Bank.

5.2.2 The report shall include, but not be limited to the following:

5.2.2.1 Information reflecting the Licensee’s financial condition within and outside the Sultanate;
5.2.2.2 Information showing in detail the assets and liabilities of the Licensee;
5.2.2.3 The amount and character of local and foreign currency held by the Licensee;
5.2.2.4 The amount, nature and maturities of all items and instruments, securities and other investments owned or held by the Licensee, to the extent that such information is related to the conduct of banking business within and outside the Sultanate.

5.2.3 Foreign Licensees shall also file copies of all reports prepared within the Sultanate for submission to banking authorities which have jurisdiction over the foreign Licensee and which reflect the aggregate financial condition of all operations of such Licensee.
6. **Other External Audit Issues**

6.1 **Central Bank Access to External Auditors**

6.1.1 The Central Bank may establish direct access with the external auditors in the circumstances when it considers that such contacts are necessary to ensure financial integrity, or whenever found necessary.\(^{24}\)

6.2 **External Auditor’s Access to Outsourcing Providers**

6.2.1 Licensees must ensure that their internal and external auditors have timely access to any relevant information they may require to carry out their duties.

6.3 **Co-operation with External Auditors**

6.3.1 Licensee must take reasonable steps to ensure that their staff:

6.3.1.1 Provide support to the external auditor to carry out its responsibilities;

6.3.1.2 Provide the external auditor with the right to access relevant records and information;

6.3.1.3 Do not interfere with the external auditor’s ability to discharge its duties;

6.3.1.4 Do not provide false or misleading information to the external auditor; and

6.3.1.5 Report to the external auditor any matter which may significantly affect the financial position of the Licensee.

6.4 **External Auditors’ Notifications to the Central Bank**

6.4.1 Licensees are directed to ensure that their respective external auditors advise the Central Bank on matters of governance interest, material violations committed by the Licensees, adverse changes in the risks of the Licensee’s business, and any other matters which have supervisory implications. Licensees are directed to incorporate the aforementioned aspects in their contracts with external auditors.\(^{25}\)

6.5 **Tri-lateral Meeting**

6.5.1 Licensees and their external auditors shall attend the tri-lateral meetings convened by the Central Bank to discuss issues relating to the audits, the implementation of accounting standards and evolving uniform accounting practices.\(^{26}\)
7. Internal Audit Function

7.1 Reporting Responsibilities of the Internal Audit Department

7.1.1 All Licensees shall strictly comply with the following requirements in regard to their internal audit departments’ reporting responsibilities: 27

7.1.1.1 The heads of the internal audit department of all domestically incorporated Licensees shall directly report to the Board of Directors of the Licensees; and

7.1.1.2 The heads of the internal audit department of all foreign Licensees shall directly report to Oman-resident Chief Executive Officer (“CEO”).

7.1.1.3 This shall not undermine the independent functioning of the internal audit and respective regional office/head office should ensure compliance and efficacy of the function.

7.2 Internal Audit Best Practices

7.2.1 Licensees are advised to review their existing internal audit function vis-a-vis the principles stated in the Basel Committee paper titled “Internal Audit in Banks and the Supervisor’s Relationship with Auditor”. 28

7.2.2 Licensees are advised to review all the principles, particularly principles 1-12, 16, 19 and 20. 29

7.2.3 Licensees shall ensure adequacy of internal audit and obtain prior approval of the Central Bank for the position of Head of Internal Audit. Windows of foreign bank branches should take up with the Central Bank any other acceptable arrangement. Licensees are required to note that any change in the incumbency of the head of internal audit department and the circumstances for the change should immediately be brought to the Central Bank’s notice. 30

7.2.4 The Central Bank shall hold a one-to-one meeting with the head of the internal audit department when he has been relieved of duties. 31
8. Central Bank Examiners

8.1 Role of Examiners

8.1.1 The examiners shall inspect the operations of the Licensees to assess their compliance with the relevant provisions of the Central Bank laws and regulations and, where relevant, industry best practices. The Licensees shall provide the examiners with all relevant records and information.

8.2 Frequency of Examination

8.2.1 At such times as the Central Bank may deem necessary and at least once during each fiscal year of the Central Bank, a Licensee examiner shall make a thorough examination of the banking activities and fiscal affairs of each Licensee and of some or all of the branches of such Licensee. 32

8.3 Appointment of Examiners

8.3.1 The Central Bank shall appoint examiners, who shall be employees of the Central Bank or under a contract with the Central Bank, to examine the affairs of the Licensees. 33

8.3.2 In case the examiners are not employees of the Central Bank and are appointed under a contract, the following is applicable:

8.3.2.1 The examiners shall be appointed in writing, through an appointment letter, by the Central Bank. In each case, the Central Bank will decide on the range, scope and frequency of work to be carried out by the examiners;

8.3.2.2 The Central Bank may appoint one or more of its officials to work on the examiners’ team for a particular Licensee; and

8.3.2.3 The examiners and external auditors shall not be the same entity / person.

8.4 The Examiners’ Report

8.4.1 The examiners shall submit to the board of governors promptly after the completion of any such examination a full and detailed report about the condition of the Licensee in the form prescribed by the Central Bank. 34

8.4.2 The examiners would normally be required to report on one or more of the following aspects of a Licensee’s business:

8.4.2.1 Accounting and other records;
8.4.2.2 Internal control systems;
8.4.2.3 Operations of certain departments; and / or
8.4.2.4 Other matters specified by the Central Bank.
8.4.3 The report produced by the examiners is the property of the Central Bank but is usually shared by the Central Bank with the Licensee concerned.
8.4.4 The report should be discussed with the Licensees’ Board of Directors and / or senior management in advance of its being sent to the Central Bank, unless otherwise directed by the Central Bank.
8.4.5 The examiners shall specify in their report any limitations placed on them in carrying out their duties.
8.4.6 Licensees that fail to cooperate in any examination by the Central Bank or to submit reports required under the Banking Law may be subject to suspension or withdrawal of their license or such other sanctions as the Central Bank may decide.  

8.5 Examination Expenses

8.5.1 All expenses incurred by the Central Bank in examinations shall be borne by the Central Bank.  

8.6 Other Relevant Issues

8.6.1 Examiners should communicate the following to the Central Bank:
8.6.1.1 Any reasonable belief or concern they may have that any of the requirements of the Central Bank are not or have not been fulfilled by the Licensee;
8.6.1.2 Any significant risk of material loss in the concerned Licensee; and
8.6.1.3 Any risks regarding the interests of depositors / investment account holders of adverse changes in the financial position or in the management or other resources of a Licensee.
8.6.2 Both the examiners and the Central Bank are bound to confidentiality provisions restricting the disclosure of confidential information with regard to any such information obtained in the course of the examination. The examination report is to be confidential as referred by the Title on Powers of Supervision and Control.
9. Attachment

9.1 Minimum Disclosure Requirements in Year End Financial Statements - Forms

9.1.1 Form No. CBO/MDR/1

Format of Statement of financial position for the year ended 31st December …………………

<table>
<thead>
<tr>
<th>Assets</th>
<th>Note</th>
<th>Current</th>
<th>Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Balances with Central Bank of Oman and Other Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Deposit with Central Bank of Oman &amp; other Securities held for dealing purposes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central Bank Islamic Sukuk</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances due from H.O. Branches, Principal Shareholders &amp; Affiliates abroad</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net inter-branch transactions (domestic)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due from Financial Institutions:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Placements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Domestic</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interbank Mudaraba</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interbank Musharaka</td>
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<td></td>
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<tr>
<td>Interbank Wakala</td>
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<td></td>
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</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Overseas</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Interbank Mudaraba</td>
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<td></td>
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<tr>
<td>Interbank Musharaka</td>
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<tr>
<td>Interbank Wakala</td>
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<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Islamic Financing</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Islamic Financing other than Financial Institutions</td>
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<td></td>
</tr>
<tr>
<td>a. Corporate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Retail</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Others</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Net of financing loss provisions &amp; reserve profit)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ijarah Receivable</td>
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</tr>
<tr>
<td>Investments</td>
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<td></td>
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### Assets

<table>
<thead>
<tr>
<th>Note</th>
<th>Current Year</th>
<th>Previous Year</th>
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<tr>
<td>Ijarah Muntahia Bittamleek</td>
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</tr>
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<td>Musharaka Investments</td>
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<tr>
<td>Mudaraba Investments</td>
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<td></td>
</tr>
<tr>
<td>Investment in Properties</td>
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<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
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<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total Assets**

Customers’ Liabilities under:

(i) Letters of Credit

(ii) Guarantees

(iii) Others

Total of Contra Items

Assets pledged as security | 11 | |

### Shareholders’ Equity, Unrestricted Investment Accounts & Liabilities

<table>
<thead>
<tr>
<th>Note</th>
<th>Current Year</th>
<th>Previous Year</th>
</tr>
</thead>
</table>

**Shareholders’ Equity**

Share Capital* / Assigned Capital #

Legal Reserves * / Deposit with CBO #

General Reserves

Properties fair value reserve

Investment fair value reserve

Retained Earnings

Other Equity Items:

a) 

b)
<table>
<thead>
<tr>
<th>Shareholders’ Equity, Unrestricted Investment Accounts &amp; Liabilities</th>
<th>Note</th>
<th>Current</th>
<th>Previous</th>
</tr>
</thead>
</table>

(A) Total Shareholders’ Equity

Unrestricted Investment Accounts 9

Types of Investment Accounts
a) 

b) 

c) 

Bank’s Share as Mudarib

Profit Equalization Reserve

Investment Risk Reserve

(B) Total Unrestricted Investment Accounts

Liabilities

Current Accounts 9

Due to H.O., Branches & Affiliates abroad 2

Net inter-branch transactions (domestic)

Due to Financial Institutions:

(i) Placements

a. Domestic

Interbank Mudaraba

Interbank Musharaka

Interbank Wakala

Other

b. Overseas

Interbank Mudaraba

Interbank Musharaka

Interbank Wakala

Other

(ii) Short and long term Financing: 8

a. From Central Bank

b. Others

► (C) Total Liabilities

► (D) Shareholders’ Equity, Unrestricted Investment Accounts and Liabilities (A + B + C)

Liabilities under:

(i) Letters of Credit 6
Shareholders’ Equity, Unrestricted Investment Accounts & Liabilities

(ii) Guarantees

(iii) Others

Total of Contra Items
Commitments to lend and unused credit lines

Aggregate of the net Foreign Currency Exposures

Aggregate amount of secured liabilities 11

* Applicable to Domestic Licensees
# Applicable to Foreign Licensees

9.1.3 Form No. CBO/MDR/3
Format of Profit and Loss Account for the year ended 31st December ………...

Details

RO 000s

1. Net Income from Islamic Financing
   a) Profit from Islamic Financing

Less: b) Expenses on Islamic Financing

2. Net Income from Sukuk and Interbank
   a) Income from Sukuk and Interbank

Less: b) Expense on Sukuk and Interbank

3. Return on unrestricted investment accounts
   a) Gross return on unrestricted investment accounts

   a) Bank’s share as a Mudarib

4. Dividend Income

5. Net Fee & Commission Income
   a) Fee and Commission Income

Less: b) Fee and Commission Expense

6. Net Foreign Exchange Income
   a) Income

Less: b) Expense
<table>
<thead>
<tr>
<th>Details</th>
<th>Note</th>
<th>Current</th>
<th>Previous</th>
</tr>
</thead>
<tbody>
<tr>
<td>7. Unrealised gain (loss) on equity type instruments carried at fair value through statement of income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Gain (loss) on sale of equity type instruments carried at fair value through equity</td>
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<tr>
<td>9. Net Income from Other Investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: b) Expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Income from Subsidiaries</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Income from Associate Companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Income from Other Licensed Activities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Other Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Operating Income</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Staff Expenses</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>General Administrative Expenses</td>
<td>12</td>
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</tr>
<tr>
<td>Other Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Operating Costs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Net Operating Profit (Profit on ordinary activities before provisions)

<table>
<thead>
<tr>
<th>Details</th>
<th>Note</th>
<th>Current</th>
<th>Previous</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision Written Off</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Provisions Written Back</td>
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<td></td>
</tr>
<tr>
<td>General Provisions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specific Provision for Financing Losses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for Impairment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Provisions</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Profit for the Year</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Authorised Signatory (Licensee)**

**Name & Signature (Auditing Firm)**

---

9.1.4 Form No. CBO/MDR/4

**Statement of Retained Profits for the year ended 31st December ………...**

<table>
<thead>
<tr>
<th>Details</th>
<th>Note</th>
<th>Current</th>
<th>Previous</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit for the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained Earnings brought forward from previous year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profits available for appropriation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Proposed Appropriations:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal Reserves</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Reserves</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zakah</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Dividend *</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Details</td>
<td>Note</td>
<td>Current</td>
<td>Previous</td>
</tr>
<tr>
<td>----------------------------------------------</td>
<td>------</td>
<td>---------</td>
<td>----------</td>
</tr>
<tr>
<td>Stock Dividend *</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remittance to Head Office #</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Allocations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unappropriated Profits carried forward</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Applicable only for Domestic Licensees 
#Applicable only for Foreign Licensees
9.1.5 Form No. CBO/MDR/5

Assets and Liabilities of ………………… …………………………………… … Bank
As of 31st December,
RO 000s

<table>
<thead>
<tr>
<th>Assets</th>
<th>Current</th>
<th>Previous</th>
<th>Liabilities</th>
<th>Current</th>
<th>Previous</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash Balances with Central Bank and Other Banks</td>
<td></td>
<td></td>
<td>1. Current Accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Capital Deposit with Central Bank</td>
<td></td>
<td></td>
<td>2. Due to HO., branches, principal shareholders &amp; affiliates abroad</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Government &amp; other securities</td>
<td></td>
<td></td>
<td>3. Due to Financial Institutions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Central Bank Islamic Sukuk</td>
<td></td>
<td></td>
<td>i) Placements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Due from H.O., branches, principal shareholders &amp; affiliates abroad</td>
<td></td>
<td></td>
<td>ii) Islamic Financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i) Placements</td>
<td></td>
<td></td>
<td>Unrestricted Investment Accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii) Islamic Financing</td>
<td></td>
<td></td>
<td>1. Investment Accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Islamic Financing Other than FI</td>
<td></td>
<td></td>
<td>2. Profit Equalisation Reserve</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Ijarah Receivable</td>
<td></td>
<td></td>
<td>3. Investment risk reserve</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Investments</td>
<td></td>
<td></td>
<td>Shareholders’ Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Ijarah Muntahia Bittamleek</td>
<td></td>
<td></td>
<td>1. Share Capital * / Assigned Capital #</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Musharaka Investments</td>
<td></td>
<td></td>
<td>2. Legal Reserves * / Deposit with CBO #</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Mudaraba Investments</td>
<td></td>
<td></td>
<td>3. General Reserves</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Investment in Properties</td>
<td></td>
<td></td>
<td>4. Properties fair value reserve</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Fixed Assets</td>
<td></td>
<td></td>
<td>5. Investment fair value reserve</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15. Other Assets</td>
<td></td>
<td></td>
<td>6. Retained Earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
<td></td>
<td><strong>Total Liabilities, Unrestricted Investment Accounts and Shareholders’ Equity</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Applicable for Domestic Licensees

# Applicable for Foreign Licensees
9.2 Minimum Disclosure Requirements in Year End Financial Statements -

Notes

1. Eligible Islamic Sukuk are Sukuk issued by the Central Bank:

<table>
<thead>
<tr>
<th>Sl</th>
<th>Details</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>At 1 January</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Acquisitions</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Disposals and redemptions</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>At 31 December</td>
<td></td>
</tr>
</tbody>
</table>

Refer to Forms CBO/MDR/1 and CBO/MDR/5

2. Placement of Licensees funds abroad with Head Office / Principal Shareholders / Own Branches and / or Affiliates

A. For Domestic Licensees

<table>
<thead>
<tr>
<th>Sl</th>
<th>Details</th>
<th>Amount</th>
<th>% of Networth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Principal Shareholders &amp; their own branches / offices abroad (aggregate)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>At each affiliates of Principal Shareholders abroad</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Branches of domestic banks abroad (aggregate)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Total</td>
<td></td>
<td></td>
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</tbody>
</table>

B. Foreign Licensees

<table>
<thead>
<tr>
<th>Sl</th>
<th>Details</th>
<th>Amount</th>
<th>% of Networth</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

RO 000s
<table>
<thead>
<tr>
<th>Sl</th>
<th>Details</th>
<th>Amount</th>
<th>% of Networth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Head Office and Own Branches abroad</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>At each Head Office affiliate abroad</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Refer to Forms CBO/MDR/1 and CBO/MDR/5

3.a. Investments

<table>
<thead>
<tr>
<th>Type of Investments</th>
<th>Cost</th>
<th>Market Value</th>
<th>Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt type instruments carried at amortised cost</td>
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<td></td>
</tr>
<tr>
<td>Unquoted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity type instruments carried at fair value through equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quoted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unquoted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity type instruments carried at fair value through statements of income</td>
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</tr>
<tr>
<td>Quoted</td>
<td></td>
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<td></td>
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<tr>
<td>(i)</td>
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<td></td>
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<tr>
<td>(ii)</td>
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<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Refer to Form CBO/MDR/1
3.b. Ijarah Muntahia Bitamleek

<table>
<thead>
<tr>
<th>Description</th>
<th>Land</th>
<th>Buildings</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Cost</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 1 January</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additions</td>
<td></td>
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<td></td>
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<tr>
<td>Disposals</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>At 31 December</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Depreciation</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 1 January</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provided During the Year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relating to disposed assets</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>At 31 December</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Book Value at 31 December</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.c. Musharaka and Mudaraba Investments

<table>
<thead>
<tr>
<th>Description</th>
<th>Real Estate</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Musharaka Investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for Impairment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Musharaka Investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for Impairment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.d. Investment in Properties

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td></td>
</tr>
</tbody>
</table>
4.a. Reconciliation of changes in the provisions for financing losses and reserve profit as per the format below:

<table>
<thead>
<tr>
<th>Details</th>
<th>Reserve Profit</th>
<th>Specific Provisions</th>
<th>General Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current yr</td>
<td>Previous yr</td>
<td>Current yr</td>
</tr>
<tr>
<td>At 1 January</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provided/Added during the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Written back during the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Written-off during the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At 31 December</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Only the cumulative amount of general provisions, specific financing loss provisions and reserve profit are to be disclosed in a note on the summarized Statement of financial position required to be published in the newspaper. Refer to Form CBO/MDR/5.

4.b. Financing to single obligor and senior members

<table>
<thead>
<tr>
<th>SI</th>
<th>Details</th>
<th>Single Obligors*</th>
<th>Senior Members*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>No. of clients</td>
<td>Amount</td>
</tr>
<tr>
<td>1</td>
<td>On-balance sheet exposure</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2. Off-balance sheet exposure

*All Single Obligors or Senior Members (including Senior Management, Board of Directors, Shari’a Board Members and Internal Shari’a Reviewer) and their related parties who have availed credit facilities exceeding 10% of the Licensee’s networth, without considering any collaterals / guarantees etc.

5. Any single item under ‘Other Assets’ representing 20% or more of the total Other Assets to be disclosed. Items in the nature of deferred charges, irrespective of the amount thereof should be disclosed separately.

6. Contingent items

<table>
<thead>
<tr>
<th>Sl.</th>
<th>Details</th>
<th>Amount RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Claims against the bank not acknowledged as payable</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Net Foreign Currency Exposure</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Other</td>
<td></td>
</tr>
</tbody>
</table>

Refer to Form CBO/MDR/2

7. Licensees are required to disclose under this item, separately, income earned from each of the subsidiaries and associated companies as defined by Circular BM 407 or as would be extant, while finalizing the financial statements. Additionally, under the Banking Law 2000 as required by the Banking Regulations framed thereunder banks are required to obtain separate license for undertaking certain activities (e.g. investment banking etc.). Income from each of the licensed activity listed under BM/REG/32/12/88 (e.g. Investment Banking, etc is required to be disclosed under this item. Refer to Form CBO/MDR/3.

8. Placements with / from any other Licensees and financial institutions individually and / or constituting a single group comprising holding company, subsidiaries, affiliates including branches representing 20% or more of the total placements or networth of the reporting Licensees whichever is lower has to be disclosed separately. The name and other particulars of the group are not required to be given in the Financial Statements which are for publication in newspaper or otherwise. However, these details have to be disclosed to the Central Bank for its confidential use. The disclosure in the financial statements meant for publication could be like this „„ „„% (percent) of total placements / the reporting bank’s networth is with / from number of entities (all the related entities to be considered as one entity). Refer to Forms CBO/MDR/1 and CBO/MDR/2

9. The particulars of deposits are required to be furnished in the following format (Form CBO/MDR/2):
### Islamic Banking Regulatory Framework

<table>
<thead>
<tr>
<th>Deposits</th>
<th>From</th>
<th>Government</th>
<th>Banks</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>This year</td>
<td>Last year</td>
<td>This year</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>URIA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Refer to Form CBO/MDR/2

10. A specific disclosure is required to be made separately showing the aggregate amount included in the statement of financial position for Islamic financing on which profit is not being accrued and the basis used to determine the carrying amount of such Islamic financing. Refer to Form CBO/MDR/1.

11. A specific disclosure is required to be made showing separately the aggregate amount of secured liabilities and the nature and carrying amount of the assets pledged as security. Refer to Forms CBO/MDR/1 and CBO/MDR/2.

12. Any single item constituting more than 10% of the total of “General Administrative Expenses” should be disclosed separately. Refer to Forms CBO/MDR/3.

13. A specific disclosure is required to be made of the capital structure and its adequacy based on the system of computation formulated by the Basel Committee. Refer to Forms CBO/MDR/2.

#### 9.3 Documents / Forms to be Submitted to the Central Bank

9.3.1 Scheme of Appropriation and Distribution of Profit for the Year  
(applicable only for domestically incorporated banks)

<table>
<thead>
<tr>
<th>SI No</th>
<th>Details</th>
<th>Amount RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Net Profit for the year</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Retained Earnings brought forward</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Transfer from Reserves (please specify)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Transferred to Legal Reserve</td>
<td></td>
</tr>
</tbody>
</table>
### Islamic Banking Regulatory Framework

<table>
<thead>
<tr>
<th>SI No</th>
<th>Details</th>
<th>Amount RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Transferred to Statutory Reserve</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Transferred to Investment Fluctuation Reserve</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Transferred to General Reserve</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Transferred to any other Reserve (please specify)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Proposed Cash Dividends</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Proposed Stock Dividends</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Any other appropriations (please specify)</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Retained Earnings</td>
<td></td>
</tr>
</tbody>
</table>

- Net profit for the year should tally with the profit and loss account
- Under ‘Any other appropriations’ the details are to be specified.
- Total of items 1 to 3 should match with the total of items 4 to 15.

9.3.2 Performa for Reporting Details of Profits Proposed to be Remitted to Head Office by Foreign Licensees Operating within the Sultanate of Oman

Name of the Licensee: ___________________________ Financial Year: ___________________________

<table>
<thead>
<tr>
<th>SI No</th>
<th>Details</th>
<th>Amount RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Income during the year</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Expenditure during the year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. Within the Sultanate of Oman</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. H.O. expenses</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Net profit as per the Profit &amp; Loss Account</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>H.O. Expenses charged to P&amp;L Account of the Oman offices of the bank</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Actual provisions made</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. For Tax</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. For financing loss provisions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. For impairment in Investments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. For terminal benefits in respect of the staff</td>
<td></td>
</tr>
<tr>
<td>SI No</td>
<td>Details</td>
<td>Amount RO 000s</td>
</tr>
<tr>
<td>-------</td>
<td>-------------------------------------------------------------------------</td>
<td>----------------</td>
</tr>
<tr>
<td></td>
<td>i) Staff recruited and held on the rolls of the Oman offices</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii) Staff posted by the Corporate Office / Controlling Office with item wise break-up</td>
<td></td>
</tr>
<tr>
<td></td>
<td>e. For any other purpose, with item wise break-up</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Amount transferred to reserves (give details)</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Adjustment towards outstanding tax liabilities of previous years, if any</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Amount, if any, retained within the Sultanate for meeting Capital Adequacy requirements</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Amount to be remitted to Head Office</td>
<td></td>
</tr>
</tbody>
</table>

Along with the format duly filled in, a copy of the latest income tax clearance certificate is to be attached to facilitate expeditious disposal.
9.3.3 Schedule of Classified Financing with Specific Loss Provisions and Reserve Profit held as at 31- Dec- xxx

<table>
<thead>
<tr>
<th>S.No</th>
<th>Name of the Customer</th>
<th>Status of Classification As at 31-Dec…</th>
<th>As per Examiner’s list (Reference Date: )</th>
<th>Balance outstanding as at 31-Dec…</th>
<th>Value of Securities (as per Central Bank extant norms)</th>
<th>Specific Provisions required as per Central Bank norms</th>
<th>Specific Provisions required as per AAOIFI norms</th>
<th>Specific Provisions held</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Outstdg Balance</td>
<td>Reserve Profit</td>
<td>Eligible Securities</td>
<td>Specific Provisions</td>
<td>Balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A.</td>
<td>As per Examiners List (in the same order)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B.</td>
<td>Accounts not classified by Examiners, but classified by the Licensee / External Auditors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
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<td></td>
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<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C.</td>
<td>Other Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total (A+B+C)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Names of the customer should appear in the same order as appearing in the Examiner’s list
- Value of Securities are to be computed on the basis of paras 13.7 and 13.8 of Circular BM 977
- Total of outstanding balance as at 31st December should tally with the figures indicated in the financials.
- Aggregate Provisions held should be higher, on a portfolio basis, of that determined under the Central Bank’s or AAOIFI norms
9.3.4 Schedule of Account-Wise Movement of Specific Provisions and Reserve Profit for The Year xxx

<table>
<thead>
<tr>
<th>No.</th>
<th>Name of the customer</th>
<th>Made during the year</th>
<th>Written back/released during the year</th>
<th>Written off during the year</th>
<th>Suspended during the year</th>
<th>Written back/released during the year</th>
<th>Written off during the year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
</tbody>
</table>

A. As per Examiner’s List (in the same order)

B. Accounts not classified by Examiners, but classified by the Licensee / External Auditors

C. Other Accounts

Total (A+B+C)

- Total under Column 3 should tally with the provisions made during the year as per P&L Account
- Total under Columns 3 to 8 should tally with the movement in provisions and reserve profit indicated under Notes on Accounts.
9.3.5 Schedule on Summary Movement of Provisions and Reserve Profit

<table>
<thead>
<tr>
<th>Details</th>
<th>Reserve Profit</th>
<th>Specific Provisions</th>
<th>General Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Year</td>
<td>Previous Year</td>
<td>Current Year</td>
</tr>
<tr>
<td>Opening Balance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provided during the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Written back / released during</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Written off during the year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing Balance</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Figures indicated should tally with the Notes on Account
### 9.3.6 Schedule Adequacy of Provisions as at 31-Dec-xxx

<table>
<thead>
<tr>
<th>Sl No</th>
<th>Details</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross Islamic Financing</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Of which,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. Standard</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>b. Special Mention</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>c. Sub-standard</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>d. Doubtful</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>e. Loss</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Personal financing-Standard</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Personal financing-Special Mention</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Specific Provisions required as per Attachment II</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Specific Provisions held as at 31-Dec- …</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>General Provision required on Personal Financing @ 2% {(7+8)*.02}</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>General Provision required on Other Financing @ 1% {(2+3-7-8)*.01}</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>General Provisions held as at 31-Dec- …</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Total Provisions required (9+11+12)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Total Provisions held (10+13)</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Provision shortfall, if any (if 14 &gt; 15, 14-15)</td>
<td></td>
</tr>
</tbody>
</table>
9.3.7 Schedule on restructured / rescheduled Financing

<table>
<thead>
<tr>
<th>Sl</th>
<th>Name of the Customer</th>
<th>Month of Restructuring / Rescheduling</th>
<th>Classification at the time of Restructuring / Rescheduling</th>
<th>Classification of the Examiner</th>
<th>Balance outstanding as at 31st Dec-.....</th>
<th>Classification as at 31- Dec.....</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A. Accounts criticized by the Examiner</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>B. Accounts not criticized by the Examiner and with an outstanding balance of RO.100,000 &amp; above</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sl</td>
<td>Summary of Restructured / Rescheduled Accounts</td>
<td>No. of accounts</td>
<td>Balance outstanding as 31-Dec…..</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>----</td>
<td>-----------------------------------------------</td>
<td>-----------------</td>
<td>---------------------------------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Standard financing Accounts restructured / rescheduled</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Special Mention financing Account - restructured / rescheduled Sub-</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>standard financing Accounts-restructured / rescheduled Doubtful</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Financing Accounts-restructured / rescheduled</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Financing Accounts-restructured / rescheduled</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Total Restructured / Rescheduled Accounts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Total Restructured / Rescheduled Amount should tally with the figures reported under Quarterly Monitoring Report.
9.3.8 Schedule of Assets Written-off

<table>
<thead>
<tr>
<th>Sl No.</th>
<th>Name of the Customer / Issuer</th>
<th>Gross Balance Outstanding at the time of write-off / compromise</th>
<th>Amount recovered</th>
<th>Amount written-off</th>
<th>Written-off from</th>
<th>Residual balance, if any</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Provisions held</td>
<td>Reserve Profit</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
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<tr>
<td>Total</td>
<td></td>
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</tr>
</tbody>
</table>

- Provisions and reserve profit written off should tally with the Notes on Account
- Written-off from current year’s profit should tally with the Profit and Loss account
9.3.9 Schedule of Own Investments in Shares

<table>
<thead>
<tr>
<th>Sl</th>
<th>Company Name</th>
<th>No. of Shares</th>
<th>Total Cost</th>
<th>Cost per Share</th>
<th>Closing Price/Book Value per Share</th>
<th>Market / Book Value</th>
<th>Unrealised Gain/(Loss)</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td>9</td>
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<td>10</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>
9.3.10 List of specially mentioned accounts as per Central Bank Examination Report with current balance

<table>
<thead>
<tr>
<th>Sl No.</th>
<th>Sl No. In Examiner’s List</th>
<th>Customer’s Name</th>
<th>Amount outstanding as at the Examination Date</th>
<th>Amount outstanding as at 31-Dec-….</th>
<th>Current Classification status</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2</td>
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<td>5</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>
### 9.4 Key Differences between AAOIFI and IFRS

This table is provided for illustrative purposes only and is not a conclusive or comprehensive description. For full references of AAOIFI standards please refer to the AAOIFI guidelines.

<table>
<thead>
<tr>
<th>AAOIFI</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Accounts</strong></td>
<td></td>
</tr>
<tr>
<td>Quasi-equity</td>
<td>Financial liability</td>
</tr>
<tr>
<td>Allocation of assets</td>
<td>Carried at amortised cost</td>
</tr>
<tr>
<td>On or off balance sheet</td>
<td>Accrual of associated funding cost</td>
</tr>
<tr>
<td>Sharing of profit and losses on declaration</td>
<td></td>
</tr>
<tr>
<td>Disclosure implications</td>
<td></td>
</tr>
<tr>
<td>Associated reserves may be created (PER and IRR)</td>
<td></td>
</tr>
</tbody>
</table>

| **Unrealised Losses Arising From Changes In Fair Value of investment in real estate** | |
| Recognised under the statement of income | Cumulative negative changes in fair value under the statement of changes in equity |

| **Fair Value Gains / Losses On Investment Properties** | |
| Recognised as a separate fair value reserve as a part of shareholders’ equity | If accounted under the fair value model to be taken to the income statement |

| **Lease** | |
| Rentals booked as expense by lessee and income by lessor | It would be treated as finance leases irrespective of the form of the agreement. |
| No concept of principal repayments | |
| At the end of lease term ownership can transfer under a separate contract | |

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1. Article 1, BM 974
2. Article 2, BM 974
3 Article 2, BM 974
4 Article 2, BM 974
5 Article 3, BM 974
6 Article 4, BM 974
7 BM/REG/49/3/2004
8 Article 7, BM 974
9 Article 5, BM 974
10 Article 12, BM 974
11 BM 646
12 BM 980
13 BM 980
14 BM 980
15 BM 980
16 BM 980
17 BM 980
18 BM 980
19 BM 980
20 BM 977, Article 70 of the Banking Law and BM 980
21 BM 795
22 Article 72 of the Banking Law
23 Article 72 of the Banking Law
24 Article 9, BM 974 and BM 980
25 Article 11, BM 974b
26 Article 13, BM 974 and BM 980
27 BM 602
28 BM 919
29 BM 919
30 BM 919
31 BM 919
32 Article 73 of the Banking Law
33 Article 73 of the Banking Law
34 Article 73 of the Banking Law
35 Article 73 of the Banking Law
36 Article 73 of the Banking Law
TITLE 4: POWER OF SUPERVISION AND CONTROL

Islamic Banking Regulatory Framework
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1. **Powers of Supervision and Control**

1.1 **Scope of Coverage**

1.1.1 This Title sets out the Central Bank’s approach to enforcement of the Banking Law 2000 and rules, regulations, circulars and other instructions conveyed thereunder and the mechanisms used by the Central Bank to address failures by the Licensees in connection with them.

1.2 **Purpose of the Title**

1.2.1 This Title is a set of Rules and Guidance which aim to:

1.2.1.1 Promote integrity, fairness, transparency and confidence in the Islamic Banking Industry in Oman;

1.2.1.2 Assist in the prevention, detection and reduction of conduct that may damage the Licensees in any manner; and

1.2.1.3 Provide the appropriate protection to all the stakeholders.
2. Powers

2.1 General Power

2.1.1 The Board of Governors of the Central Bank may withdraw the license or suspend operations of any Licensee in the Sultanate or impose such other sanctions as may be appropriate under the circumstances for failure to comply with directives or policies of the Central Bank or for any violation of the provisions of the Banking Law, the rules, regulations and instructions of the Central Bank and other applicable laws of the Sultanate.

2.1.2 The Board of Governors may also enforce the above if it determines that a Licensee is in an unsound or unsafe condition or that such suspension or other sanction would be in the best interest of depositors / Investment Account Holders in the Sultanate and to take possession of any suspended Licensee, administer it during the period of suspension and, when deemed necessary, to liquidate and close or to reorganize such Licensee or to reopen or to order, at any time, the sale in whole or in part of business, property, assets and/or liabilities of such Licensee. The Central Bank can also take any other similar actions pursuant to the requirements of the Banking Law and the rules, regulations and instructions of the Central Bank promulgated thereunder.¹

2.2 Powers of Administration of Banks, Involuntary Dissolution and Liquidation

2.2.1 The Board of Governors may take possession of the business and property of any domestic Licensee and the business and property within the Sultanate of any licensed foreign bank, suspend the license and administer its business and property during any period of suspension, suspend the operations of any Licensee for a specified period, or cause the liquidation or termination of the business of any Licensee.

2.2.2 The Board of Governors may authorize the reopening or require reorganization before a subsequent reopening or order at any time the sale in whole or in part of business property, assets and/or liabilities of such a Licensee whenever it shall appear that such Licensee:

2.2.2.1 Has actually failed or the circumstances indicate that it will fail to comply with the orders, directives or policies of the Board of Governors;
2.2.2.2 Has actually violated or the circumstances indicate that it will violate any applicable provisions of the Banking Law, rules and regulations and instructions issued thereunder or of any other law of the Sultanate;

2.2.2.3 Has accepted or may accept deposits / investment accounts at a time when the Licensee is in an unsafe or insolvent condition or it appears that the Licensee is or may be unable to pay valid claims fully as they become due;

2.2.2.4 Is conducting its business or the business of any authorized branch in an unauthorized, unsafe manner or is in an unsound, unsafe condition to transact or continue to transact banking business;

2.2.2.5 Has an impairment of its capital;

2.2.2.6 Has suspended or is in danger of suspending the payment of any of its obligations; or

2.2.2.7 Has not been carrying on banking business.

2.2.3 In addition to the above provisions, the Board of Governors in the case of a licensed foreign bank shall have the authority to exercise its powers, as above, if such foreign bank has got its license revoked or suspended or prohibited to carry on that business or is the subject of a liquidation or administration proceeding or any other proceeding having an equivalent effect in the jurisdiction in which it is organised or domiciled or in any other jurisdiction in which it is conducting a banking business or if it appears that a licensed foreign bank is carrying on a banking business in any jurisdiction without a valid license or if the Central Bank is not satisfied that the bank is subject to adequate supervision by the appropriate regulator in its home state or if there is a reason to believe that such bank will or may be unable to fully pay valid claims as they become due.

2.2.4 The Board of Governors shall appoint an administrator for any Licensee whose operations have been suspended or otherwise affected by actions of the Board of Governors. Under the direction of the Board of Governors, the administrator shall take possession of the books, records and assets of each and every description of such Licensee and shall be authorized to take such action as may be necessary to conserve its assets, pending further disposition of its business as provided by law, to operate or supervise the continued operation or reorganization of such Licensee or to supervise the liquidation and cessation of banking activities by the Licensee.

2.2.5 The Board of Governors may delegate the administrator to acquire all rights, title and interest in all property, assets and liabilities of such Licensee and its branches and shall, at any time, discharge them in whole or in part whether they are located
within or outside the Sultanate, such right of discharges including the right of sale, in whole or part, or any other similar actions pursuant to any directions of the Board of Governors and the Licensee shall be bound by and liable in respect of all actions performed and all documents executed by the administrator whatsoever in the exercise of such power and authority.

2.2.6 Without prejudice to the above, an administrator appointed hereunder shall be authorized to operate or supervise the operation of a Licensee for a period of not more than one year from the date of action by the Board of Governors. The administrator appointed shall be required to undertake the liquidation of such Licensee, if the Board of Governors determines that the Licensee continues to be subjected to the same conditions necessitating initial action.

2.2.7 Without prejudice to the above provisions, if the Board of Governors determines that the business of a Licensee shall be terminated and that such assets shall be liquidated, the administrator appointed hereunder shall make provision for the payment of persons protected under the provisions applicable to Licensees and shall then pay the remainder of the proceeds, if any, to a liquidator or other administrator authorized to take possession and distribute the assets of each and every description pursuant to the Commercial Companies Law or the applicable law of the jurisdiction in which the concerned bank is organized or domiciled as the case may be. Such person shall then become responsible for the liquidation or other distribution of the assets of the Licensee pursuant to the provisions of the Commercial Companies Law or the applicable law of the jurisdiction in which the concerned bank is domiciled or organized as the case may be.\(^2\)
3. Violations / Non-Compliance

3.1 Regulatory Requirements

3.1.1 The Central Bank has a set of procedures, as illustrated below, which it follows whilst exercising its supervisory powers over the Licensees. If such rules are not followed by the Licensees, they will be treated as violation / non-compliance of the requirements stipulated by Central Bank and various enforcement measures, as outlined in this Title, may be used to enforce the same.

3.2 Reports

3.2.1 Each Licensee shall submit to the Central Bank an annual report, audited by independent external auditors pursuant to the procedures established by the Central Bank and such other interim reports and a monthly report at such times and in such forms as may be prescribed by the Central Bank.

3.2.2 The reports required must be accurate and shall include but not be limited to the information reflecting the financial condition of the Licensee within and outside the Sultanate. The reports must show in detail the assets and liabilities of the Licensee, the amount and character of domestic and foreign currency held by the Licensee and the amount, nature and maturities of all items and instruments, securities and other investments owned or held, to the extent that such information is related to the conduct of authorized banking business within and outside the Sultanate. Licensed foreign banks shall also file copies of all the reports prepared within the Sultanate for submission to banking authorities which have jurisdiction over the licensed foreign bank and which reflect the aggregate financial condition of all operations of the Licensee.

3.2.3 Each Licensee shall also submit such other reports concerning the condition of the Licensee or any one or more of its branches at such times and in such form as may be prescribed by the Central Bank.

3.2.4 Any reports as required and showing assets and liabilities of the reporting Licensee shall be published in such manner and at such times as may be prescribed by the Central Bank. These shall be displayed in the Head Office and each of its branches (if any) in a conspicuous place, accessible to any interested party, within five days after submission of the reports, and shall remain on display for a period of not less than one month.
3.2.5 Notwithstanding these provisions, any report submitted to the Central Bank pursuant thereto shall be made available to the depositors / Investment Account Holders of the Licensee and to the public in such manner as the Central Bank may determine and with such protection as may be necessary to ensure the confidentiality of relations between a Licensee and its depositors / Investment Account Holders and other customers.

3.2.6 Each Licensee shall make available to its depositors / Investment Account Holders within the Sultanate on demand a copy of its annual report submitted to its shareholders.³

3.3 **Bank Examinations**

3.3.1 The Central Bank shall appoint bank examiners, who are employees of the Central Bank or under contract to the Central Bank, to examine the affairs of the Licensees and shall establish the procedures for such examinations.

3.3.2 The Central Bank may deem it necessary at least once during each fiscal year to have a bank examiner make a thorough examination of the banking activities and fiscal affairs of each Licensee and of any or all of the branches of such Licensee. The bank examiner shall submit to the Board of Governors promptly after the completion of any such examination a full and detailed report of the condition of the Licensee so examined in the form prescribed by the Central Bank.⁴

3.4 **Failure to Submit Reports**

3.4.1 If a Licensee fails to cooperate in any examination by the Central Bank or to submit reports required under the Banking Law 2000, it shall be subject to suspension or withdrawal of its license or such other appropriate sanctions.⁵

3.5 **Maintaining the Confidentiality of Examination Reports**

3.5.1 The examination reports, prepared by the bank examiners appointed by the Central Bank, are strictly for confidential use only and emphasis is placed on the Licensees and any of their directors, officers or employees that they should not under any circumstances disclose the contents of the report or any portion thereof to their depositors / Investment Account Holders and other interested parties without the prior approval of the Central Bank.⁶

3.6 **Display of the Banking License**
3.6.1 Each Licensee and the branches thereof, which are operating within the Sultanate of Oman, shall display the License at all times in a conspicuous place in the Licensee’s Head Office as well as branches. Failure to comply may render a Licensee liable to either or both of the following sanctions:

3.6.1.1 The suspension of operations of the Licensee concerned;

3.6.1.2 A fee by way of penalty not more than the license fee, for each business day on which the license is not displayed.  

3.7 Safety of Operations

3.7.1 If the Licensee fails to carry out business with safety of the general public in mind or is carrying operations in conflict with the Banking Law of 2000 or Regulations, the Central Bank may order the Licensee to cease or restrict any operation or the total of its activities in addition to any other actions provided for by the Banking Law of 2000.

3.7.2 If a Licensee violates or is not complying with the Banking Law or Regulations issued there under, the Central Bank shall in addition to any action taken pursuant to above, impose any of the sanctions mentioned in the Banking Law of 2000 and regulations issued thereunder.

3.8 Types of Compliance Failings

3.8.1 There can be several types of compliance failings, for example:

3.8.1.1 A Licensee’s repeated failures to respond to formal requirements for information from the Central Bank;

3.8.1.2 A Licensee’s failure to make needed requirements or to address significant inaccuracies / inadequacies in the regulatory reporting to the Central Bank;

3.8.1.3 A Licensee submitting false and/or misleading information to the Central Bank.
### 3.9 Investigations

3.9.1 The Central Bank can order investigations of any Licensee at any given time so as to ensure that there is full compliance with the provisions of the rules laid out under the Banking Law.

3.9.2 *Such investigations may be carried out either by the Central Bank’s own officials or others appointed by the Central Bank.*

3.9.3 Failure by a Licensee to cooperate fully with the Central Bank or to respond to its examination reports within set period of time will be treated as demonstrating a material lack of cooperation with the Central Bank.

### 3.10 Remedy of Compliance Failings

3.10.1 Payment of a financial penalty does not by itself absolve a Licensee from remedying the compliance failure concerned. The Central Bank will expect the Licensee to address the contravention within a reasonable timescale, to be set on a case-by-case basis. Failure to do so may result in other measures being considered.

3.10.2 Remediying violation or non-compliance may not bar supervisory action set hereunder.
4. Sanctions

4.1 Types of Sanctions

4.1.1 In case of a Licensee’s failure to comply with directives or policies of the Central Bank or of any breach or violation of the provisions of the Banking Law or rules, regulations and instructions issued thereunder, the Central Bank may have the option of imposing any one or more the following sanctions:

4.1.1.1 The withdrawal of the banking license of a Licensee and/or any or all of its branch offices within the Sultanate;

4.1.1.2 The suspension of operations of a Licensee and/or any or all of its branches within or outside the Sultanate;

4.1.1.3 The imposition of a fee by way of penalty of not more than the annual license fee (for the Licensee or branch as the case may be) to be assessed and charged for each business day during any period where an occurrence, defined as above, has been determined to exist by the Central Bank;

4.1.1.4 Denial of access to credit facilities of the Central Bank.

4.1.2 Before imposing the sanctions as described above, the Central Bank may notify the offending Licensee and accord an opportunity to remedy its failure, breach or violation.

4.1.3 Islamic banking bestows greater burden of responsibility on Licensees so far as Shari’a compliance is concerned.

4.1.4 Shari’a non-compliance risks arising from failure to comply with Shari’a rules, principles and requirements, as set by the respective Shari’a Supervisory Board of the Licensee or any other body nominated for the purpose, have implications not only for continuity of operations of the Licensee but also for various stakeholders including Investment Account Holders, regulators and the industry.

4.1.5 In view of the seriousness of the matter, the Central Bank shall view such Shari’a violations / non-compliance more sternly, looking for adherence in letter and spirit and imposing commensurate penalties otherwise.
5. **General Approach to Enforcement**

5.1 **Guiding Principles**

5.1.1 The Central Bank will adopt such an approach in enforcement that it will attempt to ensure prudence, diligence and compliance in all banking related matters.

5.1.2 The Central Bank will have a consultative / proactive process to mitigate scope for failures / punitive action.

5.1.3 The Central Bank may do special investigation in the course of its proceedings and requires utmost cooperation from the Licensees in this regard.

5.1.4 The Central Bank will assess the individual circumstances of each violation / non-compliance, as the case may be, committed by the Licensees against the general objectives of protecting the Licensees, their stakeholders and the market as a whole.

5.1.5 While ignorance or negligence shall not be condoned, conscious and deliberate violations and non-compliance of provisions, inappropriate practices and acts, particularly non-appreciative of regulatory concerns and guided by overwhelming business considerations, shall receive more severe penalties.

5.1.6 The Central Bank’s approach in determining to use a particular measure will take into account the seriousness of each such act committed or omitted. This will include the severity of the risks posed to the concerned Licensee, depositors / Investment Account Holders, the Islamic banking sector and the banking system as a whole.

5.1.7 The Central Bank will also take into account the circumstances and compliance track record of the Licensees concerned including any new or persisting weaknesses in the Licensees’ system and negligent / unjustifiable behaviour by the Licensees.

5.1.8 The period of violation / non-compliance, number of branches where it is committed, number of accounts in which it occurred and inadequacies in basic policies and procedures leading to such acts will also decide the severity of enforcement measures.

5.1.9 Licensees are mandated to investigate into every act of violation / non-compliance whether it is brought out either by internal control set up (like compliance and audit) or the Central Bank. They should take suitable punitive and remedial measures and also ensure that scope for such acts is eliminated for
future. The Central Bank will also look into these aspects in reckoning enforcement.

5.1.10 The Central Bank may displace any of the directors / Chief Executive / General Manager / DGMs / AGMs / Officers / employees of the Licensees in order to safeguard the Licensees and the depositors / Investment Account Holders. Licensees should take appropriate action themselves.

5.1.11 The following shall also be deemed to be against the safety of the Licensees:

5.1.11.1 The concerned incumbent ceasing to conform to fit & proper criteria;

5.1.11.2 Any information coming up to go against the basis for initial judgment of conformity;

5.1.11.3 The incumbent involvement in any destructive or oppressive practices casting doubt on his integrity or involving in any association with any other business practice / conduct casting doubt of his competence or soundness of his judgment.

5.1.12 Depending upon materiality of act, circumstances, larger implications and the severity of penalty, the Central Bank may instruct the Licensee to have the same disclosed under requirements of market discipline or otherwise.

5.1.13 The Licensee shall adopt institution-specific approach to “Guidance” noting that ignoring them when appropriate to it will tantamount, at the Central Bank’s discretion, to violation or non-compliance of rules and regulations. The Licensee should appreciate the regulatory norms in letter and spirit. In general, the Licensee is envisaged to act with prudence and diligence reasonably expected of it so as to avoid adverse regulatory observations and penalties.

5.1.14 Remedying a violation or non-compliance in the course of examination observations and other processes may not necessarily bar the enforcement action or lessen the severity of action.

5.1.15 The Central Bank shall weigh the risk of inappropriate enforcement actions, at the same time creating positive incentives and encouraging an open and collaborative relationship with its Licensees.

5.1.16 The Central Bank shall view seriously and take commensurate action in case the Licensee distorts investigative proceedings by providing misleading information, tampering with records or doing similar acts.

5.1.17 The Central Bank will use the fundamental principle of proportionality in its enforcement approach, which means that it will reserve its more serious enforcement measures such as imposition of penalty and cancellation of a license,
among others, for the more serious acts. A less serious act will attract a milder form of enforcement such as the issuance of a formal warning.

5.1.18 *It is possible for the Central Bank to consider intermediary courses like suspension or barring a particular line of business or business outlets, barring business or branch expansion, denying regulatory approval, etc. The Central Bank may consider issuance of formal warnings and financial penalties before enforcing more serious sanctions.*
6. **Formal Warning**

6.1 **Introduction**

6.1.1 Formal warnings are one of the enforcement measures of the Central Bank.

6.1.2 The formal warning issued sets out the Central Bank’s concerns to a Licensee regarding an issue, and it must be viewed with the appropriate degree of seriousness by the Licensee.

6.1.3 *The Central Bank may discuss any concerns it has with a Licensee prior to resorting to the issuance of a formal warning.*

6.1.4 *If such discussions fail to resolve matters to the Central Bank’s satisfaction, a formal warning may be issued. A formal warning may be issued with or without any prior discussions with the Licensee, and is entirely under the discretionary powers held by the Central Bank.*

6.2 **Procedure to Follow When Issuing a Formal Warning**

6.2.1 The Licensee will be given 30 or less days, depending upon the issue involved, from the issuance of the formal warning within which the Licensee needs to make its submissions to the Central Bank in writing.

6.2.2 If the Licensee does not respond in time or adopts dilatory approach, the Central Bank shall presume that the Licensee does not have any explanation to offer and proceed accordingly.

6.2.3 The Central Bank may, generally, take not more than 30 days to make a final determination concerning the submission made by the Licensee regarding the concerns raised.

6.2.4 *If the Central Bank believes that immediate action is required to prevent real damage to Oman’s financial markets, then commensurate severe enforcement measures may be applied immediately.*

6.3 **Requests for Additional Information**

6.3.1 The Central Bank may require specific additional information regarding the contravention committed by a Licensee, as observed by the Central Bank. It is mandatory for the concerned Licensee to respond to the Central Bank’s requirements within the set time.
6.3.2 Failure by a Licensee to respond to such requirement within the deadline set by the Central Bank will be viewed as a significant breach of regulatory requirements and will attract commensurate enforcement penalty without any further reference.
7. **Financial Penalties**

7.1 **Introduction**

7.1.1 This is another enforcement measure which can be implemented by the Central Bank and may include the following:

7.1.1.1 Any violation of or omission to comply with any of the provisions of the Banking Law 2000 will carry a penalty of RO 10,000 per single incidence of violation / non-compliance;

7.1.1.2 The violation of and/or non-compliance with rules and regulations issued by the Board of Governors of the Central Bank will carry a penalty of RO 5,000 per single incidence of violation / non-compliance;

7.1.1.3 The violation of and/or non-compliance with the circulars issued by the Central Bank of Oman will carry a penalty of RO 2,500 per single incidence of violation / non-compliance.

7.1.2 If there are any recurrences of the above violations / non-compliance with the circular(s) of the Central Bank irrespective of penalties imposed and/or waivers granted earlier, the penalty will be double the amount stated above.

7.1.3 The above matrix of penalties is a minimum penalty structure. Further to this the Central Bank at its discretion may resort to any or more of the enforcement measures outlined in this Title. These measures may be inclusive of forfeiture of pecuniary gains made from the violation and/or non-compliance.

7.1.4 Before imposing the penalties and/or sanctions detailed above, the Central Bank may notify the offending institution and afford reasonable opportunity to justify / remedy its failure, breach or violation.

7.1.5 *Some of the instructions under the regulations or circulars may be specifically called for under the Banking Law and violation or non-compliance of such instructions shall be viewed as violations or non-compliance of the provisions of the Banking Law.*

7.2 **Procedure to Follow When Imposing a Financial Penalty**

7.2.1 A written financial penalty notice will be addressed to the Chairman / CEO / GM / Country Manager of the Licensee concerned and will include the following:

7.2.1.1 A description of the violation / non-compliance concerned;

7.2.1.2 The factors justifying the level of penalty proposed.
7.2.2 The Licensee may have a maximum of 30 days or less, as will be stated by Central Bank, from the date of notification to submit any submission it wishes to make to the Central Bank in writing.

7.2.3 The Central Bank shall debit the Licensee’s account with the Central Bank and intimate the Licensee if no submission is made within the time given or if the Licensee’s submission is not satisfactory.\(^9\)
8. **Prompt Correction Action (PAC) Framework**

8.1.1 Licensees are required to maintain a minimum CAR of 12% of risk-weighted assets. The existence of weak banks poses a continuing challenge for the supervisors and any delays in dealing with such banks has serious supervisory implications, besides potential disruptions to the financial markets. Accordingly, supervisors across various jurisdictions have robust methods – preventive measures, early identification, corrective action and resolution and exit strategies – to ensure stability of the financial system. The corrective actions, one of the important methods, are designed to deal with the deficiencies and to bring about changes in the behaviour of the Licensees in the Sultanate.

8.1.2 The Banking Law 2000 provides for suspending the licenses or operations, liquidation or termination of business of those Licensees which fail to comply with the provisions of the Banking Law and directives, conduct business in an unsafe manner, have impairment in capital, fail to meet obligations, etc. While these provisions are sufficient to deal with banks showing serious supervisory concerns, specific rules are necessary to deal with early signs of weaknesses. Even though the Central Bank, as part of its off-site surveillance mechanism, has been taking suitable measures where early signs of weaknesses are noticed, a formal framework is necessary to strengthen the supervisory oversight mechanism and to achieve greater transparency in the supervisory practices in the Sultanate.

8.1.3 Accordingly, the Central Bank has put in place a Prompt Corrective Action (PCA) framework as an integral part of the supervisory oversight in addition to the existing supervisory measures. The PCA is based on pre-determined, rule-based and structured early intervention to enhance the existing supervisory practices. A schedule of corrective actions, as indicated in the Annexure, is provided based on two important indicators – Asset Quality and Capital Adequacy. Certain trigger points have been determined for the PCA framework under these indicators, taking into account the practicability of implementation of the measures. The trigger points based on Asset Quality (Non Performing Assets (NPAs) net of reserve profits to Gross financing net of reserve profits and fresh NPAs to opening Standard and Special Mention financing (on an annualized basis) and Capital Adequacy are quantifiable and transparent.

8.1.4 For every trigger point, a set of corrective actions – mandatory and discretionary – is provided. The actions are designed to address both the symptoms and the causes of the weaknesses, so as to pre-empt any deterioration in the soundness of
the Licensees. If a Licensee’s performance under any one of the indicators has breached the trigger point, the Licensee would automatically be placed under the PCA framework. The corrective actions would consist of specific mandatory actions and some discretionary actions, which in the opinion of the Central Bank, should be applied to the concerned Licensee. The published balance sheets, off-site returns, on-site examination reports, external auditors/rating agencies reports, etc. would be the primary sources of data for identifying the Licensee which should be placed under the PCA framework.

8.1.5 The degree or the package of actions would be corresponding to the severity of the problem. In cases where Licensees do not show improvement, despite taking the corrective actions, more or severe actions might be considered if there is a heightened danger of insolvency. Further, the total PCA framework for a Licensee, on the basis of the severity of the position, would be determined by aggregating the corrective actions under different trigger points.

8.1.6 The corrective actions under the PCA framework would be enforced within 30 days of a Licensee breaching any of the trigger points. The mandatory and discretionary actions along with the timeframe for taking corrective actions will be communicated to the concerned Licensee, in writing, and the progress would be monitored at quarterly or more frequent intervals, as deemed necessary.

8.1.7 Notwithstanding anything contained in the PCA framework, the Central Bank has the right to direct a Licensee to take any other action or implement any other directive in the interest of the concerned Licensee or in the interest of its depositors or the public. Non-compliance with the recommended actions under the PCA framework would entail imposition of penalties and sanctions under the provisions of the Banking Law and other directions.

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1 Article 14 (g) of the Banking Law
2 Article 83 of the Banking Law
3 Article 72 of the Banking Law
4 Article 73 of the Banking Law
5 Article 74 of the Banking Law
6 BM 415
7 Regulation BM/REG/011/11/77
8 BM 962
9 BM 962
10 BM 1091
TITLE 5: CAPITAL ADEQUACY

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1. **Introduction**

1.1 **Purpose**

1.1.1 The purpose of this Title is to set out the norms for the calculation of capital requirements. Capital is one of the important indicators of safety and soundness of the Licensees. It serves as the base for Licensees’ organic growth, and as a cushion against unexpected and stress losses. Adequacy of capital indicates the ability of the Licensees in meeting contingencies without compromising the interests of the depositors/Investment Account Holders (IAHs) and to provide credit across the business cycles. Sufficient capital, commensurate with the risk profile, would also promote public confidence and financial stability. Low levels of capital heighten the risk of bank failures, while too high a level would lead to inefficient use of capital. The supervisors across jurisdictions where Islamic banking was adopted as an authorised way of banking have been using varying prudential parameters for regulating the capital base of Islamic Banks and Islamic Windows.

1.1.2 The Central Bank is committed to adopt international best practices, standards and codes. As a part of this declared policy, the Central Bank has adopted the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II)* from Basel Committee for Banking Supervision for banks operating in Oman.

1.1.3 The Central Bank recognises that the Basel Committee guidelines may not fully address specific characteristics of the various products and services offered by the Licensees due to the unique nature of institutions offering Shari’a compliant financial services. Therefore, the Central Bank has adopted a risk-based approach and has tailored the Rules to address the specific risk characteristics of the Licensees. These norms are mostly consistent with the approach recommended by the Basel Committee on Banking Supervision and Islamic Financial Services Board (IFSB) for capital adequacy.

1.1.4 The norms illustrated under this Title provide the Capital Adequacy Standard for Licensees offering Islamic or Shari’a compliant financial services. These standards are applicable to Licensees that mobilise funds as deposits and investment accounts in accordance with Shari’a rules and principles, and invest them in Shari’a compliant investment and financing instruments.

1.1.5 The objectives of the Standard are to:

1.1.5.1 Address the specific structure and contents of the Shari’a compliant products and services and Shari’a compliant risk mitigation that are not specifically addressed by the currently adopted and proposed international capital adequacy standards;
1.1.5.2 *Standardise the approach in identifying and measuring risks in Shari’a compliant products and services and in assigning Risk Weights (RW), thereby creating a level playing field amongst the Islamic financial institutions in adopting and developing risk identification and measurement practices that meet internationally acceptable prudential standards.*

1.1.5.3 *Ensure adequacy of capital and improve the ability of the Licensees in meeting contingencies without compromising the interests of the depositors/investment account holders, to provide financing through the business cycles and to maintain the stability of the banking system.*

1.2 **Scope of Application**

1.2.1 The Capital Adequacy norms shall be applicable uniformly to all domestically incorporated Licensees on a global level and on a consolidated basis to any holding company that is the parent entity within a banking group for capturing the risk exposures of the whole banking group.

1.2.2 Banking groups are groups that engage predominantly in banking activities. Further, majority owned or controlled banking entities, securities entities and other financial entities - financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking - should be fully consolidated.

1.2.3 In respect of foreign banks operating in the Sultanate, these norms would be applicable only to their Oman operations.

1.2.4 If the Licensees have investments in other entities, the Licensees must also apply the rules set out in Article 2.7 and 2.8 for Capital Consolidation and Deduction Requirements for the calculation of their solo and consolidated Capital Adequacy Ratio (CAR).

1.2.5 Licensees shall seek specific approval before taking capital benefits by way of issuing Sukuk, consolidation of significant capital investments, etc.

1.3 **Structure**

1.3.1 Capital Adequacy Rules are organised into three distinct pillars. These are:

1.3.1.1 First pillar - Minimum capital requirements

1.3.1.2 Second Pillar - Supervisory review process
1.3.1.3 Third pillar - Market discipline

1.3.2 Licensees should continue their efforts in improving their existing risk management practices, MIS, technology, training of human resources, etc. to enable them to meet the minimum requirements of the Internal Rating Based Approaches (IRBA) for credit risk, the Standardised and Advanced Measurement Approaches (AMA) for operational risk and the Internal Models Method (IMM) for market risk. Licensees that meet the minimum requirements for adopting the above advanced approaches have the option to approach the Central Bank with their plans and roadmaps that have the approval of their Board of Directors for migration to these approaches. The roadmaps should clearly indicate specific signposts and plans for migration to the advanced approaches. The migrations to the advanced approaches require Licensees to meet a rigorous set of standards which provides a level of comfort as to the accuracy of the risk estimates and an appropriate control and oversight mechanism. The Capital Adequacy rules approaches for credit risk (standardised, internal ratings-based - foundation and advanced) and operational risk (basic indicator, standardised and advanced measurement) are based on increasing risk sensitivity and allow Licensees to choose any of the approaches that are most appropriate to their risk management practices.
2. **Minimum Capital Requirements**

2.1 **Regulatory Capital**

2.1.1 The capital ratio is computed using the definition of regulatory capital and risk weighted assets. All Licensees are required to maintain a minimum Capital Adequacy Ratio of 12% on an ongoing basis under this capital adequacy framework.

2.1.2 *The capital base for complying with the capital standards is quite distinct from the accounting capital. The regulatory capital is broadly classified into two categories - Tier 1 and Tier 2.*

2.2 **Minimum Capital**

2.2.1 Full-fledged domestic Islamic banks shall maintain a minimum paid in capital of RO 100 million. Islamic Windows of domestic conventional banks shall maintain a minimum allocated capital of RO 10 million. Foreign banks commencing business in Oman through Islamic banking branches shall have minimum of RO 20 million assigned to them. Foreign banks already operating in Oman and opening Islamic banking branches shall have minimum RO 10 million assigned to Islamic banking branches.

2.2.2 Both domestic conventional banks and foreign banks having Islamic banking branches shall meet their minimum capital requirement in addition to capital allocated for their Islamic banking operations.

2.2.3 Islamic banking Windows shall maintain a minimum capital of RO 10 million in addition to minimum capital requirement for their conventional operations.

2.3 **Capital Adequacy Formula**

2.3.1 CAR shall be calculated by applying the regulatory capital to the numerator and risk-weighted assets (RWAs) to the denominator.

\[
\text{Eligible Capital} = \begin{cases} 
\text{Total Risk-Weighted Assets (Credit}^b + \text{Market}^b \text{ Risks) Plus Operational Risks} \\
\text{Less} \\
\text{Risk-Weighted Assets funded by Restricted PSIA}^c (\text{Credit}^b + \text{Market}^b \text{ Risks) Less}
\end{cases}
\]
\[(1 - \alpha) [\text{Risk-Weighted Assets funded by Unrestricted PSIA}^c (\text{Credit}^b + \text{Market}^b \text{Risks})] \]
\[\text{Less} \]
\[\alpha [\text{Risk-weighted Assets funded by PER and IRR of Unrestricted PSIA}^e (\text{Credit}^b + \text{Market}^b \text{Risks})]\]

a) Total RWAs include those financed by both restricted and unrestricted Profit Sharing Investment Accounts (PSIA);

b) Credit and market risks for on- and off-balance sheet exposures;

c) Where the funds are commingled, the RWA funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR) or equivalent reserves;

d) The capital amount invested by PSIA is not guaranteed. Any losses arising from the assets financed by PSIA are borne by the IAHS. In practice the Licensee may forego his Mudarib share to provide a competitive return to its depositors/IAHs. This effectively transfers the risk back to the Licensee. Such transfer of risk is also known as Displacement of Commercial Risk. Displaced Commercial Risk (DCR) is further discussed in Article 2.13. \(\alpha\) refers to the proportion of assets funded by unrestricted PSIA which, as determined by the Central Bank, is 30%. The Central Bank will review the adequacy of \(\alpha\) from time to time and amend when deemed necessary; and

e) The relevant proportion of risk-weighted assets funded by the PSIAs’ share of PER and IRR is deducted from the denominator. The PER has the effect of reducing the DCR and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.
2.3.2 The formula in section 2.3.1 is applicable as the Licensees may smooth income to
the Investment Account Holders (IAHs) as part of a mechanism to minimise
withdrawal risk and is concerned with systemic risk.

2.4 **Elements of Tier 1 Capital**

2.4.1 Items and capital instruments that qualify as Tier 1 Capital shall have the
following characteristics:

2.4.1.1 Issued and fully paid;

2.4.1.2 Non-cumulative;

2.4.1.3 Freely available and not earmarked to particular assets or banking activities;

2.4.1.4 Able to absorb losses on a going-concern basis;

2.4.1.5 Junior to depositors, general creditors and subordinated debt of the Licensee; and

2.4.1.6 Do not represent any fixed charge on the earnings of the Islamic Banking
institution.

2.4.2 Tier 1 capital consists of:

2.4.2.1 Issued and fully paid ordinary shares;

2.4.2.2 General reserves;

2.4.2.3 Legal / statutory reserves;

2.4.2.4 Share premium;

2.4.2.5 Capital redemption reserves;

2.4.2.6 Excluding fair value reserves;

2.4.2.7 Other disclosed reserves;

2.4.2.8 Retained profits brought forward from the previous financial year less current
unaudited losses and retained losses from the prior financial year yet to be
recognised;

2.4.2.9 Unrealized net gains arising from fair valuing equities taken through P&L; and

2.4.2.10 Minority interests in subsidiaries’ Tier 1 equity, arising on consolidation, in the
equity of subsidiaries that are less than wholly owned.

2.4.3 For foreign banks, Tier 1 capital would include:

2.4.3.1 Assigned capital;
2.4.3.2 Capital deposits;
2.4.3.3 Retained earnings (available on a long-term basis);
2.4.3.4 Profit-free funds from Head Office, etc.
2.4.3.5 The cumulative unrealized gains or losses on available for sale securities accounted for directly through the equity should be reckoned separately and necessary adjustments, as indicated in Article 2.5.2.3, should be made.

2.5 Elements of Tier 2 (Supplementary) Capital

2.5.1 Items or capital instruments which do not meet all of the Tier 1 capital characteristics but which contribute to the underlying strength of a banking institution would be included in total capital as Tier 2 or supplementary capital.

2.5.2 Tier 2 capital consists of:
2.5.2.1 Undisclosed reserves
2.5.2.1.1 Undisclosed or hidden reserves are those reserves which often have characteristics similar to equity and disclosed reserves. These elements have the capacity to absorb unexpected losses and can be included in capital, if they have passed through the profit and loss account and are not encumbered by any known liability and are not routinely used for absorbing normal or operating losses.

2.5.2.2 Asset valuation reserves
2.5.2.2.1 Asset revaluation reserves, which arise from the revaluation of fixed assets and real estate from time to time in line with the change in market values, and are reflected on the face of the balance sheet as a revaluation reserve.

2.5.2.2.2 Similarly, gains may also arise from revaluation of Investment Properties (real estate). These reserves (including the net gains on investment properties) may be included in Tier 2 capital, with the concurrence of the external auditors, provided that the assets are prudently valued. A discount of 55% will be applied to the difference between the historical cost book value and the market value to reflect the potential volatility of this form of unrealised capital.

2.5.2.3 Licensees should not reckon the latent (revaluation) reserves in respect of their own premises.

2.5.2.3 Revaluation reserves / cumulative fair value gains or losses on available for sale
2.5.2.3.1 Revaluation reserves or unrealized gains on ‘available for sale’ equity securities alone can be included among supplementary elements of capital, provided such capital could be used to absorb losses on a going concern basis and that a haircut of 55% on the difference between the historic cost book value and market value is applied in order to cushion against market volatility and tax charges, while determining their value for inclusion in Tier 2 capital.

2.5.2.3.2 Such reserves shall be reflected in the financial statements as retained earnings.

2.5.2.4 General provisions

2.5.2.4.1 General provisions, if they are not ascribed to identified deterioration of any specific asset or grouped assets or known liabilities and are freely available to meet unidentified (expected) losses, can be included in Tier 2 capital.

2.5.2.4.2 Licensees must ensure that sufficient specific provisions have been made to meet all incurred or known losses and foreseeable potential losses before considering general provisions to be part of Tier 2 capital.

2.5.2.4.3 Further, general provisions against identified deterioration in assets in real estate financing and in other problem sectors should not be reckoned for capital purposes. However, general provisions held for the purpose of meeting country risk are also eligible to be considered as part of the Tier 2 capital.

2.5.2.4.4 Licensees are allowed to include the general provisions, including those on country risk, on performing accounts i.e. risk classified as standard and special mention, in Tier 2 capital, subject to the condition that aggregate of such provisions should be admitted as Tier 2 capital only up to a maximum limit of 1.25% of the total risk-weighted assets. While reckoning general provisions as Tier 2 capital, such provisions should not be netted from the financed assets for computing the risk-weighted assets.

2.5.2.5 Profit equalisation reserve and investment risk reserve

2.5.2.5.1 Licensees are allowed to include PER and IRR up to a maximum amount equal to the capital charge pertaining to 30% of the risk weighted assets financed by unrestricted IAH in Tier 2 capital.
2.6 **Subordinated Sukuk and Innovative Tier 1**

2.6.1 Unlike in conventional banking Shari’a compliance and compliance of Innovative Tier 1 and Subordinated Sukuk may not be clear at the outset. The items under this category would be allowed subject to the approval of the Central Bank on a case-by-case basis. These instruments should be subject to limits prescribed in Article 2.9.

2.7 **Capital Consolidation**

2.7.1 To the greatest extent possible, all banking and other relevant financial entities which are subsidiaries of a Licensee will be captured through consolidation (or aggregation) for regulatory capital purposes (or deducted in line with Article 2.8). Thus majority owned or controlled banking entities, securities entities (where such activities are subject to broadly the similar set of regulations or where securities activities are deemed banking activities) and other financial entities should generally be fully consolidated or aggregated for regulatory capital purposes. Licensees must notify the Central Bank of their proposed regulatory aggregation or consolidation approaches and agree them with the Central Bank and their external auditors.

2.7.2 When recognising consolidated capital for regulatory capital purposes, the Central Bank will assess the appropriateness of including minority interest(s) arising from the consolidation of less than wholly owned banking, securities and other financial entities.

2.7.3 Significant investments (20% - 50%) in banking, securities and other financial entities will be consolidated or aggregated on a pro-rata basis for regulatory capital purposes unless deducted in accordance with Article 2.8.

2.7.4 The parent bank will be required to demonstrate that other significant shareholders have the means and the willingness to proportionately support the financial entity. The bank should have joint control in the investee entity along with other parties. If there is no joint control and a single party can exercise control, pro-rata consolidation for regulatory capital purposes cannot be applied.

2.8 **Capital Deductions**

2.8.1 The Licensees should enforce the following deductions from the capital base for the purpose of calculating the capital adequacy ratio.
2.8.2 From Tier 1 Capital:

2.8.2.1 Goodwill, irrespective of the accounting treatment.

2.8.2.2 Intangible assets including losses, cumulative unrealized losses recognised directly in equity.

2.8.2.3 Shortfall in provisions of any nature.

2.8.2.4 Deferred tax asset.

2.8.2.5 Reciprocal crossholdings of bank capital artificially designed to inflate the capital position of banks.

2.8.3 Equally from Tier 1 and Tier 2 capital:

2.8.3.1 Any investments in the capital of banks and other financial entities other than reciprocal cross-holdings of bank’s capital.

2.8.3.2 Significant minority and majority investments in commercial entities that exceed 5% of the Licensee’s regulatory capital for individual significant investments and 20% of the Licensee’s regulatory capital for aggregate of such investments.

2.8.4 Islamic banks are required to deduct, equally from Tier I and Tier II capital, any investments in the capital of banks and other financial entities, other than reciprocal cross-holdings of bank capital. Reciprocal cross-holdings of bank capital are to be deducted entirely from Tier I capital.

2.8.5 Minority investments in banks / financial entities as under any strategic investments made in banks / financial entities either with or without Board level participation, both within and outside the Sultanate, are to be deducted from capital, equally from both Tier I and Tier II capital. Non-strategic investments made in banks / financial entities up to either 5% of the capital of investee bank / financial entity or 5% of the net worth of the investing bank, whichever is lower, shall be risk weighted at a minimum of 100%, without the requirement of deduction of capital.

2.8.6 Non-strategic investments made in banks / financial entities beyond 5% of the capital of investee bank / financial entity or 5% of the net worth of the investing bank shall be deducted from the capital, equally from both Tier I and Tier II capital.

2.8.6.1 When measuring regulatory capital for banks, the equity holdings in a Takaful / insurance entity of 20% or more of the investee’s capital shall be required to be deducted from the Licensee’s capital for regulatory capital purposes. Holdings
Islamic Banking Regulatory Framework

less than 20% will be risk weighted under the applicable credit risk weighting rules.

2.8.6.2 Shortfall in the regulatory capital requirements in the un-consolidated entities.

2.8.6.3 Investments in unconsolidated banking and financial subsidiary companies, associates or affiliates, etc.

2.8.6.4 Majority owned or controlled Takaful subsidiaries must be adequately capitalised to reduce the possibility of future potential losses to the parent bank. If it is not corrected in a timely manner, the shortfall will also be deducted from the parent bank’s capital for regulatory capital purposes.

2.8.6.5 The deduction of securitisation exposure net of specific provision from regulatory capital.

2.9 Limits on Regulatory Capital

2.9.1 Tier 1 capital should represent at least half of the total eligible capital, i.e. Tier 2 capital is limited to 100% of Tier 1 capital.

2.9.2 The limit on Tier 2 capital is based on the amount of Tier 1 capital after all deductions of investments pursuant to Capital Consolidation and Deduction Requirements.

2.9.3 General loss provisions should be limited according to Article 2.5.2.4.4 subject to conditions enumerated in 2.5.2.4.1

2.9.4 PER and IRR should be limited according to Article 2.5.2.5.1

2.9.5 The Tier 1 innovative instruments are limited to 15% of Tier 1 capital.

2.9.6 Subordinated Sukuk when specifically approved by the Central Bank to be included in Tier 2 capital, are limited to a maximum of 50% of Tier 1 capital.

2.10 Profit Sharing Investment Accounts

2.10.1 This Article deals with the capital adequacy requirement for assets financed by PSIA, a pool of investment funds placed with a Licensee, typically on the basis of Mudaraba. Where investment accounts are managed under Wakala contract, the relationship between the Licensee and the investors is a simple agency relationship with the Licensee earning a flat fee rather than a share of profit.

2.10.2 The PSIA (commonly referred to as “investment accounts” or “special investment
accounts”) can be further categorised into:

2.10.2.1 Unrestricted PSIA; and
2.10.2.2 Restricted PSIA.

2.10.3 The Licensee has full discretionary power in making investment decisions for unrestricted PSIA, but in the case of restricted PSIA the placement of funds by the Licensee is subject to investment criteria specified by the Licensee in the Mudaraba contract or agreed between the IAHs and the Licensee at the time of contracting.

2.10.4 The Licensee assumes the role of economic agent or Mudarib in placing such funds in income-producing assets or economic activities, and as such is entitled to a share (the Mudarib share) in the profits (but not losses) earned on funds managed by it on behalf of the IAHs, according to a pre-agreed ratio specified in the Mudaraba contract.

2.11 **Adjustment to the Capital Ratio Denominator**

2.11.1 The capital amount of PSIA is not guaranteed by the Licensee and any losses arising from investments or assets financed by PSIA are to be borne by the IAH except under certain circumstances as described in Article 2.12.1.

2.11.2 *In principle, therefore, the commercial risk on assets financed by the Licensee does not represent risks for the Licensee’s own (shareholders’) capital and thus would not entail a regulatory capital requirement for the Licensee. This implies that assets funded by either unrestricted or restricted PSIA would be excluded from the calculation of the denominator of the capital ratio.*

2.11.3 In practice, however, the Licensee may forgo its rights to some or all of its Mudarib share of profits in order to offer its IAHs a more competitive rate of return on their funds to mitigate potential systemic risk resulting from massive withdrawals of funds by dissatisfied IAHs.

2.11.4 *This applies particularly to unrestricted PSIA. The implications of this for capital adequacy purposes are addressed under displaced commercial risk in Article 2.13.*

2.12 **Impact on Capital**

2.12.1 The Licensee is liable for losses arising from its negligence, misconduct or breach of its investment mandate, and the risk of losses arising from such events is
characterised as a fiduciary risk. The capital requirement for this fiduciary risk is dealt with under operational risk.

2.13 **Displaced Commercial Risk**

2.13.1 *The term “displaced commercial risk” refers to the risk arising from assets managed on behalf of IAHs which is effectively transferred to the Licensee’s own capital because the Licensee follows the practice of foregoing part or all of its Mudarib share of profit on such funds, when it considers this necessary as a result of commercial pressure in order to increase the return to the IAHs.*

2.13.2 *This applies particularly to unrestricted PSIA. The rate of return paid to the IAHs is thus “smoothed” at the expense of the profits attributable to the Licensee’s shareholders. Such a situation would most often arise as a result of rate of return risk (otherwise referred to as profit rate risk), where the IAHs’ funds are invested in assets such as Murabaha or Ijarah with a relatively long maturity and at a rate of return which no longer meets current market expectations. However, it might also arise in respect of other market risks (such as price risk) or credit risk when a Licensee wishes to protect its IAHs from the effects of the poor performance of a portfolio of assets under its management (subject to the Shari’a prohibition of the Mudarib making good an overall loss to the investor). While in principle the Licensee has full discretion as to whether it performs this displacement of commercial risk, in practice it may find itself virtually obliged to do so.*

2.13.3 *Licensees may be obliged for competitive reasons to practice the displacement of commercial risk.*

2.13.4 *All Licensees practicing profit smoothing should include a specified percentage of assets financed by PSIA in the denominator of the CAR (represented by α in the Capital Adequacy Calculation Formula as set out in Article 2.3.1). This would apply to RWA financed by both unrestricted and restricted PSIA, unless the practice of income smoothing for IAH by the Licensee had been confined to the unrestricted PSIA.*

2.13.5 *The Central Bank has adopted a value of 30% for alpha.*

2.13.6 *Reserves*

2.13.7 *The Licensee may set up prudential reserve accounts to minimise the adverse impact of income smoothing for PSIA on its shareholders’ returns and to meet potential but unexpected losses that would be borne by the IAH on investments*
financed by PSIA, namely:

2.13.8 Profit Equalisation Reserve (PER)

2.13.8.1 PER comprises amounts appropriated out of the gross income from the Mudaraba to be available for smoothing returns paid to the IAH and the shareholders, and consists of a PSIA portion and a shareholder’s portion;

2.13.9 Investment Risk Reserve (IRR)

2.13.9.1 IRR comprises amounts appropriated out of the income of IAH after deduction of the Mudarib share of income, to meet any future losses on the investments financed by the PSIA.
3. Islamic Financing Instruments and Their Nature of Risks

3.1 Introduction

3.1.1 In Islam, the whole fabric of Divine Law is contractual in its conceptualization, content, and application. Financial intermediation following the principles of Islam is based on a set of contracts and instruments which form the backbone and building blocks for more complex and elaborate frameworks. Such contracts are grounded in the principles of risk sharing, fair dealing, no financing of sinful activities, etc.

3.1.2 Islamic financial instruments are asset-based (Murabaha, Salam and Istisna’a which are based on the sale or purchase of an asset, and Ijarah which is based on the selling of benefits of such an asset), profit-sharing (Musharaka and Mudaraba), or Sukuk (securities) and investment portfolios and funds which may be based on the above assets. In the case of asset-based instruments, the Licensee’s gross return is the spread between the cost of the asset to the Licensee and the amount that can be recovered from selling or leasing it. Such instruments may therefore involve exposure to market (price) risk in respect of the asset as well as credit risk in respect of the amount due from the counterparty. In the case of profit-sharing instruments, Musharaka and Mudaraba, the exposure is of the nature of an equity position not held for trading similar to an ‘equity position in banking book’ as described in Basel II, and is likewise dealt with under credit risk, except in the case of investments (normally short-term) in assets for trading purposes, which are dealt with under market risk. The Islamic contracts result in risk exposure to the Licensee which varies depending on the nature of the contract. On one end of the risk continuum the system offers contracts with known, pre-determined pay-off, secured by real assets while on the other end the system promotes equity participation. The Licensee may develop various product programs based on these contracts individually or as combinations. Typical contracts used are:

3.1.3 Murabaha and Murabaha for the Purchase Orderer;

3.1.4 Salam and Parallel Salam;

3.1.5 Istisna’a and Parallel Istisna’a;

3.1.6 Ijarah and Ijarah Muntahia Bittamleek;

3.1.7 Musharaka and Diminishing Musharaka;

3.1.8 Mudaraba;

3.2 Murabaha and Murabaha for the Purchase Orderer
3.2.1 This Article sets out the minimum capital adequacy requirements to cover the transactions that are based on the Shari’a rules and principles of Murabaha and Murabaha to the Purchase Orderer (MPO).

3.2.2 In Murabaha and MPO, the capital adequacy requirement for credit risk refers to the risk of a counterparty not paying the agreed price of an asset to the Licensee. In the case of binding MPOs, the risks faced by the Licensee are different at the various stages of the contract.

3.2.3 This Article is broadly divided into (a) Murabaha and non-binding MPO and (b) binding MPO, as the types of risk faced by the Licensee are different at the various stages of the contract for the two categories.

3.2.4 This classification and the distinctions between a non-binding MPO and a binding MPO are subject to the criteria and opinions set by the respective Shari’a Supervisory Boards (SSBs) of the Licensee or any other SSB as specified by the Central Bank.

3.2.5 Murabaha and Non-binding MPO

3.2.5.1 In a Murabaha transaction, the Licensee sells an asset that is already available in its possession, whereas in a MPO transaction the Licensee acquires an asset in anticipation that the asset will be purchased by the orderer/customer.

3.2.6 Binding MPO

3.2.6.1 In a binding MPO, the Licensee has no long position in the asset that is the subject of the transaction, as there is a binding obligation on the customer to take delivery of the asset at a pre-determined price. The Licensee is exposed to counterparty risk in the event that the orderer in a binding MPO does not honour his/her obligations under the Promise to Purchase (PP), resulting in the Licensee selling the asset to a third party at a price which may be lower than the cost to the Licensee. The risk of selling at a loss is mitigated by securing a Hamish Jiddiyah (HJ) (a security deposit held as collateral upon entering into agreement to purchase or agreement to lease) while executing the PP with the customer, as commonly practiced in the case of binding MPO.

3.2.7 Collateralisation

3.2.7.1 As one of the Credit Risk Mitigation (CRM) techniques, the Licensee can secure a pledge of the sold asset / underlying asset or another tangible asset (collateralised Murabaha). The collateralisation is not automatically provided in a Murabaha contract but must be explicitly stated or must be documented in a separate security agreement at or before the time of signing of the Murabaha contract. The Licensee may employ other techniques such as pledge of deposits or a third party financial guarantee. The Risk Weight of a
financial guarantor can be substituted for the RW of the purchaser provided that the guarantor has a better credit rating than the purchaser and that the guarantee is legally enforceable.

3.2.7.2 In financing transactions that are collateralised the pricing of the Murabaha assets and determination of the required amount of HJ would normally take into consideration the market value and forced-sale value of the assets and the CRM would take into account of any haircut that is applicable to the collateralised assets (if these assets are eligible collateral or acceptable to the Central Bank). Thus fluctuations in the market value and forced sale value of the collateralised assets are dealt with under credit risk assessment.

3.2.8 Credit Risk

3.2.9 Murabaha and Non Binding MPO

3.2.9.1 The credit exposure must be measured based on accounts receivable in Murabaha (the term used herein includes MPO), which is recorded at its cash equivalent value (i.e. amount due from the customers at the end of the reporting quarter less any provision for doubtful assets).

3.2.9.2 The accounts receivable (net of specific provisions) amount arising from the selling of a Murabaha asset must be assigned a RW based on the credit standing of the obligor (purchaser or guarantor) as rated by an External Credit Assessment Institution (ECAI) that is approved by the Central Bank. In case the obligor is unrated, a RW of 100% should apply.

3.2.10 Binding MPO

3.2.10.1 In a binding MPO, the Licensee is exposed to default on the purchase orderer’s obligation to pay fully for the asset at the agreed price. In the event of the orderer defaulting on its PP, the Licensee disposes of the asset to a third party. The Licensee has recourse to any HJ paid by the orderer, and (a) may have a right to recoup from the orderer any loss on disposing of the asset, after taking account of the HJ or (b) may have no such legal rights. In both cases, this risk is mitigated by the asset in possession as well as any HJ paid by the purchase orderer.

3.2.10.2 In case the Licensee has the right to recoup any loss (as indicated in the previous Article) from the orderer, that right constitutes a claim receivable which is exposed to credit risk, and the exposure should be measured as the amount of the asset’s total acquisition cost to the Licensee less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ, provided that the collateral is an eligible collateral or has been agreed as acceptable to the Central
Bank. The applicable RW must be based on the standing of the obligor as rated by an ECAI that is approved by the Central Bank, and in the case the obligor is unrated, a RW of 100% should apply.

3.2.10.3 In case the Licensee has no such right to recoup any losses, the cost of the asset to the Licensee constitutes a market risk (as in the case of a non-binding MPO), but this market risk exposure is reduced by the amount of any HJ that the Licensee has the right to retain.

3.2.10.4 In applying the treatment as set out in Article 3.2.10.2, the Licensee should ensure that the PP is properly documented and is legally enforceable.

3.2.10.5 Upon selling the asset, the accounts receivable (net of specific provisions) amount must be assigned a RW based on the credit standing of the obligor as rated by an ECAI that is approved by the Central Bank. In case the obligor is unrated, a RW of 100% should apply.

3.2.11 Exclusions

3.2.11.1 The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in Article 4.4.13 and/or (iii) any amount that is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in Article 4.4 and 4.2.12.

3.2.12 Assignment of Risk Weights

3.2.12.1 Islamic financing assets are to be categorized as per the claim categories detailed in Article 4.2, and risk weighted accordingly. Licensees should ensure that the appropriate risk weight is used based on the claim category for each transaction.

3.2.13 Market Risk

3.2.13.1 Murabaha and Non-binding MPO

3.2.13.1.1 In the case of an asset in possession for a Murabaha transaction and an asset acquired specifically for resale to a customer in a non-binding MPO transaction, the asset would be treated as inventory of the Licensee and is subject to price risk as per Article 6.5. This capital charge is also applicable to assets held by a Licensee for incomplete non-binding MPO transactions at the end of a financial period.

3.2.13.1.2 Assets in possession on a sale or return basis (with such an option included in the contract) are treated as accounts receivable from the vendor and as such would be
offset against the related accounts payable to the vendor. If these accounts payable have been settled, the assets should attract a RW based on rating of the vendor (100% in case of unrated), subject to (a) the availability of documentation evidencing such an arrangement with the vendor, and (b) the period for returning the assets to the vendor not having been exceeded. If the above conditions are not satisfied, capital charge is provided as per Article 3.2.13.1.1.

3.2.13.2 Binding MPO

3.2.13.3 In a binding MPO the orderer has the obligation to purchase the asset at the agreed price, and the Licensee as the seller is only exposed to credit risk as indicated in Article 3.2.10 above.

3.2.14 Foreign Exchange Risk

3.2.14.1 If the funding of an asset purchase or the selling of an asset opens a Licensee to foreign exchange exposures, the relevant positions should be included in the measurement of foreign exchange risk described in Article 6.3.

3.2.15 Summary of Capital Requirement at Various Stages of the Contract

3.2.15.1 The following table sets out the applicable period of the contract that attracts capital charges:

3.2.16 Murabaha and Non-binding MPO

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for sale (asset on balance sheet)</td>
<td>Not applicable</td>
<td>15% capital charge (187.5% RW)</td>
</tr>
<tr>
<td>Asset is sold and delivered to the customer, and the selling price (accounts receivable) is due from the customer</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchase price, whichever is earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

3.2.17 Binding MPO

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset available for sale</td>
<td>Asset acquisition cost less</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
3.3 Salam and Parallel Salam

3.3.1 This Article sets out the minimum capital requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the Shari’a rules and principles of Salam. The Licensee is exposed to the (a) credit (counterparty) risk of not receiving the purchased commodity after disbursing the purchase price to the seller, and (b) price risk on the amount that the Licensee incurs from the date of execution of a Salam contract, which is applicable throughout the period of the contract and beyond the maturity date of the contract as long as the commodity remains on the balance sheet of the Licensee.

3.3.2 A Salam contract refers to an agreement to purchase, at a predetermined price, a specified kind of commodity which is to be delivered on a specified future date in a specified quantity and quality. The Licensee as the buyer makes full payment of the purchase price upon execution of a Salam contract or within a subsequent period not exceeding two or three days as deemed permissible by its SSB.

3.3.3 In certain cases the Licensee may enter into a back-to-back contract (Parallel Salam) to sell a commodity with the same specification as the purchased commodity under a Salam contract to a party other than the original seller. The Parallel Salam allows the Licensee to sell the commodity for future delivery at a predetermined price (thus hedging the price risk on the original Salam contract) and protects the Licensee from having to take delivery of the commodity and warehousing it.

3.3.4 In the absence of a Parallel Salam contract, a Licensee may sell the subject-matter of the original Salam contract in the spot market upon receipt, or, alternatively, the Licensee may hold the commodity in anticipation of selling it at a higher price. In the latter case, the Licensee is exposed to price risk on its position in the
commodity until the latter is sold.

3.3.5 The non-delivery of the commodity by a Salam seller (i.e. counterparty risk) does not discharge the Licensee’s obligation to deliver the commodity under a Parallel Salam contract, and thus exposes the Licensee to potential loss in obtaining the supply from elsewhere.

3.3.6 The obligations of a Licensee under Salam and Parallel Salam are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

3.3.7 Credit Risk

3.3.7.1 The receivable amount generated from the purchase of a commodity based on a Salam contract shall be assigned a RW based on the credit standing of a seller/counterparty as rated by an ECAI that is approved by the supervisory authority. In case the seller/counterparty is unrated, a RW of 100% shall apply.

3.3.8 Exclusions

3.3.8.1 The capital requirement is to be calculated on the receivable amount, net of specific provisions, of any amount that is secured by eligible collateral as defined in Article 4.4.13 and/or any amount which is past due by more than 90 days. The portions that are collateralized and past due are subject to the relevant RW as set out in Article 4.4 and 4.2.12.

3.3.9 Applicable Period

3.3.9.1 The credit RW is to be applied from the date of the contract made between both parties until the maturity of the Salam contract, which is upon receipt of the purchased commodity.

3.3.10 Offsetting Arrangement between Credit Exposures of Salam and Parallel Salam

3.3.10.1 The credit exposure amount of a Salam contract is not to be offset against the exposure amount of a Parallel Salam contract, as an obligation under one contract does not discharge an obligation to perform under the other contract.

3.3.11 Market Risk

3.3.11.1 The price risk on the commodity exposure in Salam can be measured in two ways, either the maturity ladder approach (see Article 6.5) or the simplified approach. Under the simplified approach, the capital charge should be equal to 15% of the net position in each commodity, plus an additional charge equivalent to 3% of the gross positions, long plus short, to cover basis risk and forward gap.
risk. The 3% capital charge is also intended to cater for potential losses in Parallel Salam when the seller in the original Salam contract fails to deliver and the Licensee has to purchase an appropriate commodity from the spot market to honor its obligation.

3.3.11.2 The long and short positions in a commodity, which are positions of Salam and Parallel Salam, may be offset under either approach for the purpose of calculating the net open positions provided that the positions are in the same group of commodities.

3.3.12 Foreign Exchange Risk

3.3.12.1 The funding of a commodity purchase or selling of a commodity may well leave the Licensee open to foreign exchange exposures, and in that case the relevant positions should be included in the measures of foreign exchange risk described in Article 6.3.

3.3.13 Salam with Parallel Salam

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment of purchase price by the IIFS to a Salam customer</td>
<td>Based on customer’s rating or 100% RW for unrated customer No netting of Salam exposures against Parallel Salam exposures</td>
<td>Two applicable approaches - Maturity Ladder Approach The Simplified Approach 15% capital charge (187.5% RW equivalent) on net position (i.e. netting of Salam exposures against Parallel Salam exposures) plus 3% capital charge (37.5% RW equivalent) on gross positions (i.e. Salam exposures plus Parallel Salam exposures)</td>
</tr>
<tr>
<td>Receipt of the purchased commodity by the IIFS</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>The purchased commodity is sold and delivered to a buyer</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
3.3.14  Salam without Parallel Salam

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment of purchase price by the IIFS to a Salam customer (seller)</td>
<td>Based on customer’s rating or 100% RW for unrated customer</td>
<td>The Simplified Approach 15% capital charge (187.5% RW equivalent) on long position of Salam exposures</td>
</tr>
<tr>
<td>Receipt of the purchased commodity by the IIFS</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>The purchased commodity is sold and delivered to a buyer</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

3.4  Istimna’a and Parallel Istimna’a

3.4.1  This Article sets out the minimum capital adequacy requirement to cover credit and market (price) risks arising from entering into contracts or transactions that are based on the Shari’a rules and principles of Istimna’a. Istimna’a and parallel Istimna’a contracts would attract a risk weighting as per the credit standing of the respective counterparties.

3.4.2  An Istimna’a contract refers to an agreement to sell to or buy from a customer, a non-existent asset which is to be manufactured or built according to the ultimate buyer’s specifications and is to be delivered on a specified future date at a predetermined selling price. The Licensee, as the seller, has the option to manufacture or build the asset on its own or to engage the services of a party other than the Istimna’a ultimate buyer as supplier or subcontractor, by entering into a Parallel Istimna’a contract.

3.4.3  The exposures under Istimna’a involve credit and market risks. Credit exposures arise once the work is billed to the customer, while market (price) exposures arise on unbilled work-in-process (WIP).

3.4.4  There is a capital requirement to cater for the credit (counterparty) risk of the Licensee not receiving the selling price of the asset from the customer or project sponsor either in pre-agreed stages of completion and/or upon full completion of the manufacturing or construction process.

3.4.5  This Article also sets out the capital adequacy requirement to cater for the market risk that a Licensee incurs from the date of manufacturing or construction, which is applicable throughout the period of the contract on unbilled WIP inventory. This Article is applicable to both (a) Istimna’a contracts that are executed without a Parallel Istimna’a
contract and (b) Istisna’a contracts that are backed by independently executed Parallel Istisna’a contracts.

3.4.6 This Article makes distinctions between the two main categories of Istisna’a:

3.4.6.1 Full Recourse Istisna’a: The receipt of the selling price by the Licensee is dependent on the financial strength or payment capability of the customer for the subject matter of the Istisna’a, where the source of payment is derived from the various other commercial activities of the customer and is not solely dependent on the cash flows from the underlying asset/project.

3.4.6.2 Limited and Non-recourse Istisna’a: The receipt of the selling price by the Licensee is dependent partially or primarily on the amount of revenue generated by the asset being manufactured or constructed by selling its output or services to contractual or potential third party buyers. This form of Istisna’a faces revenue risk arising from the asset’s ability to generate cash flows, instead of the credit worthiness of the customer or project sponsor.

3.4.7 In full, limited and non-recourse Istisna’a contracts, the Licensee assumes the completion risk that is associated with the failure to complete the project at all, delay in completion, cost overruns, occurrence of a force majeure event and unavailability of qualified personnel and reliable seller(s) or subcontractors in a Parallel Istisna’a.

3.4.8 The selling price of an asset sold based on Istisna’a is agreed or determined on the contractual date and such a contract is binding. The price cannot be increased or decreased on account of an increase or decrease in commodity prices or labour cost. The price can be changed subject to the mutual consent of the contracting parties due to alteration or modifications to the contract or unforeseen contingencies, which is a matter for the commercial decision of the Licensee and can result in a lower profit margin.

3.4.9 In cases where a Licensee enters into Parallel Istisna’a to procure an asset from a party other than the original Istisna’a customer (buyer), the price risk relating to input materials is mitigated. The Licensee remains exposed to the counterparty risk of the Parallel Istisna’a seller in delivering the asset on time and in accordance with the Istisna’a ultimate buyer’s specifications. This is the risk of not being able to recover damages from the Parallel Istisna’a seller for the losses resulting from the breach of contract.

3.4.10 The failure of the Parallel Istisna’a seller to deliver a completed asset which meets the buyer’s specifications does not discharge the Licensee’s obligations to deliver the asset ordered under an Istisna’a contract, and thus exposes the Licensee to potential loss in
making good the shortcomings or obtaining the supply elsewhere. The obligations of a Licensee under Istisna’a and Parallel Istisna’a contracts are not inter-conditional or interdependent, which implies that there is no legal basis for offsetting credit exposures between the contracts.

3.4.11 Credit Risk

3.4.11.1 Full recourse Istisna’a: The receivable amount generated from the selling of an asset based on an Istisna’a contract with full recourse to the customer (buyer) shall be assigned a RW based on the credit standing of the customer as rated by an ECAI that is approved by the Central Bank. In case the buyer is unrated, a RW of 100% shall apply.

3.4.11.2 Limited and Non-Recourse Istisna’a: When the project is rated by an ECAI, the RW based on the credit rating of the project is applied to calculate the capital adequacy requirement. Otherwise, the RW shall be based on the Supervisory Slotting Criteria approach for Specialized Financing (Project Finance) as set out in Article 4.7.

3.4.11.3 In cases where a group of contractors is engaged in a particular project, the risk rating or weightage should follow the obligations of various contractors. If the risk is undertaken by a main contractor, the risk rating of the main contractor is to be used.

3.4.11.4 The limited and non-recourse Istisna’a financing structure is required to meet the characteristics as set out below in order to qualify for the treatment mentioned in Article 3.4.11.2 above:

3.4.11.4.1 The segregation of the project’s liabilities from the balance sheet of the Istisna’a ultimate buyer (or project sponsor) from a commercial and accounting perspective which is generally achieved by having the Istisna’a contract made with a special purpose entity set up to acquire and operate the asset/project concerned;

3.4.11.4.2 The ultimate buyer is dependent on the income received from the assets acquired/projects to pay the purchase price;

3.4.11.4.3 The contractual obligations give the manufacturer/constructor/Licensee a substantial degree of control over the asset and the income it generates, for example under BOT (Build, Operate and Transfer) arrangement where the manufacturer builds a highway and collects toll for a specified period as a consideration for the selling price; and
3.4.11.4.4 The primary source of repayment is the income generated by the asset/project rather than relying on the capacity of the buyer.

3.4.12 Exclusions

3.4.12.1 The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral (as defined in Article 4.4.13 and/or (iii) any amount which is past due by more than 90 days. The portions that are collateralized and past due are subject to the treatment as set out in Articles 4.4 and 4.2.12.

3.4.12.1.1 Any portion of an Istisna’a contract that is covered by an advanced payment should carry a RW of 0%, or the amount of the advanced payment should be offset against the total amount receivable or amounts owing from progress billings.

3.4.13 Applicable Period

3.4.13.1.1 The credit RW is to be applied from the date when the manufacturing or construction process commences and until the selling price is fully settled by the Licensee, either in stages and/or on the maturity of the Istisna’a contract, which is upon delivery of the manufactured asset to the Istisna’a ultimate buyer.

3.4.14 Market Risk

3.4.14.1 Full Recourse Istisna’a

3.4.14.1.1 Istisna’a with Parallel Istisna’a

3.4.14.1.2 There is no capital charge for market risk to be applied subject to there being no provisions in the Parallel Istisna’a contract that allow the seller to increase or vary its selling price to the Licensee, under unusual circumstances. Any variations in a Parallel Istisna’a contract that are reflected in the corresponding Istisna’a contract which effectively transfers the whole of the price risk to an Istisna’a customer (buyer), is also eligible for this treatment.

3.4.14.2 Istisna’a without Parallel Istisna’a

3.4.14.2.1 A capital charge of 1.6% (equivalent to a 20% RW) is to be applied to the balance of unbilled WIP inventory to cater for market risk, in addition to the credit RW stated in Article 3.4.11 above.

3.4.14.2.2 This inventory is held subject to the binding order of the Istisna’a buyer and is exposed to the price risk as described in Article 6.5.
3.4.15 Foreign Exchange Risk

3.4.15.1 Any foreign exchange exposures arising from the purchasing of input materials, or from Parallel Istisna’a contracts made, or the selling of a completed asset in foreign currency should be included in the measures of foreign exchange risk described in Article 6.3.

Full Recourse Istisna’a

Istisna’a with Parallel Istisna’a

<table>
<thead>
<tr>
<th>Applicable Contract</th>
<th>Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process inventory</td>
<td>Based on ultimate buyer’s rating or 100% RW for unrated buyer</td>
<td>Nil provided that there is no provision in the Parallel Istisna’a contract that allows the seller to increase or vary the selling price</td>
<td></td>
</tr>
<tr>
<td>Amounts receivable after contract billings</td>
<td>No netting of Istisna’a exposures against Parallel Istisna’a exposures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchased price by an Istisna’a buyer, whichever is the earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
<td></td>
</tr>
</tbody>
</table>

Istisna’a without Parallel Istisna’a

<table>
<thead>
<tr>
<th>Applicable Contract</th>
<th>Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process</td>
<td>Based on ultimate buyer’s rating or 100%</td>
<td>1.6% capital charge (equivalent to 20% RW)</td>
<td></td>
</tr>
<tr>
<td>inventory</td>
<td>RW for unrated buyer</td>
<td>on work-in-process inventory</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>Amounts receivable after contract billings</td>
<td>Based on ultimate buyer’s rating or 100% RW for unrated buyer</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the purchased price by an <em>Istisnā’</em> buyer, whichever is the earlier</td>
<td>Not applicable</td>
<td>Not applicable</td>
<td></td>
</tr>
</tbody>
</table>

**Limited or No Recourse *Istisnā’a***

**Istisnā’a with Parallel *Istisnā’a***

<table>
<thead>
<tr>
<th>Applicable Stage of the Contract</th>
<th>Credit RW</th>
<th>Market Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbilled work-in-process inventory</td>
<td>Based on buyer’s ECAI rating, if available, or supervisory slotting criteria that ranges from 70% to 250% RW</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Amounts receivable after contract billings</td>
<td>No netting of <em>Istisnā’a</em> exposures against Parallel <em>Istisnā’a</em> exposures</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Maturity of contract term or upon full settlement of the</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
3.5 Ijarah and Ijarah Muntahia Bittamleek

3.5.1 This Article sets out the minimum capital requirement to cover counterparty risk and residual value risk of leased assets, arising from a Licensee entering into contracts or transactions that are based on the Shari’a rules and principles of Ijarah and Ijarah Muntahia Bittamleek (IMB), also known as Ijarah wa Iqtinā. The Article also covers the market (price) risk of assets acquired for Ijarah and IMB.

3.5.2 In an Ijarah contract (either operating or IMB), the Licensee as the lessor maintains its ownership in the leased asset whilst transferring the right to use the asset, or usufruct, to an enterprise as the lessee, for an agreed period for an agreed consideration. All liabilities and risks pertaining to the leased asset are to be borne by the Licensee (as the lessor) including obligations to restore any impairment and damage to the leased asset arising from wear and tear and natural causes which are not due to the lessee’s misconduct or negligence.

3.5.3 Thus, in both Ijarah and IMB, the risks and rewards remain with the lessor, except for the residual value risk at the term of an IMB which is borne by the lessee. The lessor is exposed to price risk on the asset while it is in the lessor’s possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease as described in Article 3.5.5 below.

3.5.4 In an IMB contract, the lessor promises to transfer its ownership of the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a) the promise is separately expressed and independent of the underlying Ijarah; or (b) a gift contract is entered into conditional upon fulfilment of all the Ijarah obligations, and thereby ownership should be automatically transferred thereupon.

3.5.5 In both operating Ijarah and IMB, the Licensee either possesses the asset before entering into a leased contract or enters into the contract based on specific description of an asset to be leased and acquired in the future before it is delivered to the lessee. This agreement to lease may be considered as binding (binding Promise to Lease (PL)) or as non-binding (non-binding PL) depending on the applicable Shari’a interpretations.

3.5.6 Operating Ijarah: This Article sets out the minimum capital requirements to cater for the lessor’s exposures to (a) the credit risk of the lessee as counterparty in servicing the purchased price by an Istisna’a buyer, whichever is the earlier.
lease rentals, and (b) the market (price) risk attached to the residual value of the leased assets either at the end of the Ijarah contract or at the time of repossession upon default, i.e. the risk of losing money on the resale of the leased asset.

3.5.7 IMB: In IMB, once the lease contract is signed, the lessor is exposed to credit risk for the lease payments receivable from the lessee (a credit risk mitigated by the asset’s value as collateral in most cases) and to a type of operational risk in respect of the need to compensate the lessee if the asset is permanently impaired through no fault of the latter. If the leased asset is permanently impaired and is uninsured, the Licensee suffers a loss equal to the carrying value of the leased asset, just as it would if any of its fixed assets were permanently impaired. In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such case, the price risk, if any, is already reflected in a haircut to be applied to the value of the leased asset as collateral. Therefore, the price risk, if any, is not applicable in the context of the IMB.

3.5.8 This Article sets out the minimum capital adequacy requirement to cater for the credit risk of the lessee as counterparty with respect to servicing the lease rentals. The credit risk exposure in respect of the lease rentals is mitigated by the collateral represented by the value of the leased asset on repossession, provided that the Licensee is able to repossess the asset, which may be subject to doubt, especially in the case of movable assets or residential real estate. Insofar as there is doubt as to the lessor’s ability to repossess the asset, the residual fair value of the asset that was assumed in fixing the lease rentals is also exposed to credit risk.

3.5.9 The Licensee may be exposed to losses in case a lessee acquiring an asset under IMB decides not to continue with the contract. In such a case, the lessor is required to refund to the lessee the capital payments (instalments of the purchase price) that were included in the periodic lease rentals (subject to deduction of any amounts due for unpaid rentals). If the value of the repossessed asset is less than the amount to be refunded (before any such deduction), the difference constitutes a loss to the lessor. This exposes the Licensee as lessor to a form of market risk.

3.5.10 In theory, a situation could arise in which, when an IMB contract arrives at its term, the lessee decides not to exercise its option to complete the purchase by making the contractually agreed final payment (the option to purchase places no obligation on the lessee to do so). The Licensee may thus be exposed to market risk, in respect of a potential loss from disposing of the asset for an amount lower than its net book value. Generally, however, the lessor’s exposure in such a case would not be significant, as the
Moreover, the net book value of the asset at the term of the IMB (i.e. its residual fair value as assumed in fixing the lease rentals) would be zero or close to zero.

3.5.11

Credit Risk

3.5.12.1 In a binding PL, when a Licensee is exposed to default on the lease orderer’s obligation to execute the lease contract, the exposure shall be measured as the amount of the asset’s total acquisition cost to the Licensee, less the market value of the asset as collateral subject to any haircut, and less the amount of any Urbun (See article 4.4.6 for definition of Urbun) received from the lease orderer. The applicable RW shall be based on the standing of the obligor as rated by an ECAI that is approved by the Central Bank, and in the case the obligor is unrated, a RW of 100% shall apply. The Licensee may or may not have the right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ.

3.5.12.2 In applying the treatment as set out in Article 3.5.12, the Licensee must ensure that the PL is properly documented and is legally enforceable. In the absence of proper documentation and legal enforceability, the asset is to be treated similarly to one in a non-binding PL which is exposed to market (price) risk, using the measurement approach as set out in Article 6.5

3.5.12.3 Operating Ijarah: When the lessee gets the right to use the asset, the lessor is exposed to credit risk for the estimated value of the lease payments in respect of the remaining period of the Ijarah. This exposure is mitigated by the market value of the leased asset (subject to the applicable haircut) which may be repossessed (except in the case of residential real estate). The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the Central Bank. In the case that the lessee is unrated, a RW of 100% shall apply.

3.5.12.4 IMB: When the lessee gets the right to use the asset, the capital requirement for IMB is based on the total estimated future Ijarah receivable amount over the duration of the lease contract. This exposure is mitigated by the market value of the leased asset which may be repossessed (except in the case of residential real estate). The net credit risk exposure shall be assigned a RW based on the credit standing of the lessee/counterparty as rated by an ECAI that is approved by the Central Bank. In the case that the lessee is unrated, a RW of 100% shall apply.
3.5.13 The estimated future Ijarah receivable amount as indicated in Article 3.5.12 above, shall be risk-weighted based on the credit standing of the lessee as rated by an ECAI or at 100%, after deduction of the value of the leased asset as collateral (subject to any haircut).

3.5.14 Exclusions

3.5.14.1 The capital requirement is to be calculated on the receivable amount, net of (i) specific provisions, (ii) any amount that is secured by eligible collateral and/or (iii) any amount which is past due by more than 90 days. The portions that are collateralised and past due are subject to the treatment as set out in Article 4.4 and 4.2.12.

3.5.15 Market Risk

3.5.16 In the case of an asset acquired and held for the purpose of either operating Ijarah or IMB, the capital charge to cater for market (price) risk in respect of the leased asset from its acquisition date until its disposal can be categorised into the following:

3.5.16.1 Non-binding PL: The asset for leasing is treated as inventory of the Licensee and capital charge is provided for the price risk in accordance with Article 6.5.

3.5.16.2 Binding PL: In a binding PL, a Licensee is exposed to default on the lease orderer’s obligation to lease the asset in its possession. In the event of the lease orderer defaulting on its PL, the Licensee will either lease or dispose of the asset to a third party. The Licensee will have recourse to any HJ paid by the customer, and (i) may have a right to recoup from the customer any loss on leasing or disposing of the asset after taking account of the HJ, or (ii) may have no such right, depending on the legal situation. In both cases, this risk is mitigated by the asset in possession (if eligible) as well as any HJ paid by the lease orderer.

3.5.17 In case (i), the Licensee has the right to recoup any loss (as indicated in the previous Article) from the customer. This right constitutes a claim receivable which is exposed to credit risk, and the exposure shall be measured as the amount of the asset’s total acquisition cost to the Licensee, less the market value of the asset as collateral subject to any haircut, and less the amount of any HJ. The applicable RW shall be based on the standing of the customer as rated by an ECAI that is approved by Central Bank, and in the case the obligor is unrated, a RW of 100% shall apply.

3.5.18 In case (ii) the Licensee has no such right, and the cost of the asset to the
Licensee constitutes a market risk (as in the case on a non-binding PL), but this market risk exposure is reduced by the amount of any HJ that the Licensee has the right to retain.

3.5.19 Operating Ijarah: The residual value of the asset is subject to capital charge of 8%. Upon expiry of the lease contract, the carrying value of the leased asset shall carry a capital charge for price risk in accordance with Article 6.5 until the asset is re-leased or disposed of.

3.5.20 IMB: In the event that the lessee exercises its right to cancel the lease, the lessor is exposed to the residual value of the leased asset being less than the refund of payments due to the lessee. In such a case, the price risk, if any, is already reflected in a haircut to be applied to the value of the leased asset as collateral in credit risk. Therefore, the price risk, if any, is not applicable in the context of the IMB.

3.6 Musharaka and Diminishing Musharaka

3.6.1 This Article sets out the minimum capital adequacy requirement to cover the risk of loss on invested capital arising from entering into contracts or transactions that are based on the Shari’a rules and principles of Musharaka and Diminishing Musharaka where the Licensee and their customers/partner(s) contribute to the capital of the partnership and shares its profit or loss.

3.6.2 This Article is applicable to both (a) Musharaka in which all the partners’ share remains constant throughout the contract period; and (b) Diminishing Musharaka in which the share of the Licensee (as partner) shall be gradually reduced during the tenure of the contract until it is fully sold to the other partner(s).

3.6.3 Musharaka contracts refer to partnerships in specific transactions or projects. These exclude participation in the share capital (equity) of other enterprises.

3.6.4 A Musharaka is an agreement between the Licensee and a customer to contribute capital in various proportions to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a permanent basis, or on a diminishing basis where the customer progressively buys out the share of the Licensee. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Musharaka agreement whilst losses are shared in proportion to the respective contributor’s share of capital.

3.6.5 A Licensee may enter into a Musharaka contract with a customer as a means of
providing a financing to the latter on a profit sharing and loss bearing basis. In this case, the Musharaka is normally of the diminishing type, in which the customer gradually purchases the Licensee’s partnership share over the life of the contract. This type of financing is one of the Shari’a compliant alternatives to avoid a conventional term loan repayable by instalments, and as such it is exposed to credit risk for the customer’s purchase payments as well as to the risk attached to the Licensee’s share of the underlying assets.

3.6.6 The Licensee acts as a partner in a Musharaka contract and is exposed to the risk of losing its capital upon making payment of its share of capital in a Musharaka contract. A Musharaka can expose the Licensee either to capital impairment risk or to credit risk, depending on the structure and purpose of the Musharaka and the types of asset in which the funds are invested. The invested capital is redeemable either by liquidation of the Musharaka assets at the end of the contract which has a fixed tenure or as mutually agreed by the partners, or upon divestment of partnership in an on-going Musharaka subject to giving a notice to other partners. The amount of capital redemption is represented by the value of a share of capital, which is dependent on the quality of the underlying investments or assets, and ability to generate profits and cash flows from the Musharaka.

3.6.7 As a partner to a Musharaka contract, the Licensee is not entitled to a fixed rate of return and is thus exposed to variable profits generated by the partnership which are shared on a basis as agreed in the Musharaka contract, whereas losses are to be borne by the Licensee and its partners according to their respective ratio of invested capital. Therefore, the Licensee is exposed to entrepreneurial risk of an active partner that manages the partnership and business risks associated with the underlying activities and types of investments or assets of the partnership.

3.6.8 Diminishing Musharaka: This form of Musharaka is a means whereby a Licensee can provide term finance to a client on a profit and loss sharing basis. The Licensee enters into this type of Musharaka with the objective of transferring the ownership to the partner/customer, where the Licensee acts as a joint owner of the asset with a promise by the partner to purchase the Licensee’s share making a payment on one or more specified future dates. The Licensee’s selling price is normally based on the fair value of the partnership share being transferred on the date of each purchase, which may expose the Licensee to the risk of selling its share of ownership below the acquisition price.

3.6.9 As a joint owner, the Licensee is also entitled to its share of revenue generated from the assets of the Musharaka, such as Ijarah lease rentals in which the rental
entitlements to the Licensee shall be adjusted periodically according to the Licensee’s share of ownership in the asset.

3.6.10 The Licensee’s position in a Diminishing Musharaka thus entails two kinds of exposure. The amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner’s ability and willingness to pay, with the shares of the partner in the asset providing credit risk mitigation as collateral. The capital invested by the Licensee is also subject to the risk that the amount recoverable from the partner may be less than the amount invested because the value of the Musharaka assets may decrease (capital impairment risk).

3.6.11 Equity Position Risk - Musharaka

3.6.11.1 Musharaka exposures, unless deducted for regulatory capital purposes according to the framework consolidation/deduction subject in Article 2.7 & 2.8 is treated as an equity position. The capital calculation of these position is illustrated below:

3.6.11.2 Exposure in private commercial enterprises undertaking trading activities in foreign exchange, shares or commodities:

3.6.11.2.1 The RW shall be based on the applicable underlying assets as set out in the market risk section in Article 6.2.

3.6.11.2.2 The investment in foreign exchange and trading in gold shall be measured according to the treatment as set out in Article 6.3, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold/silver.

3.6.11.3 The RW of a Musharaka that invests in quoted shares shall be measured according to the equity position risk approach where positions in assets tradable in markets qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in Market Risk Article 6.2. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

3.6.11.4 Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in Article 6.5.

3.6.11.5 Musharaka exposures in the commercial enterprises other that in Article 3.6.11.2 can be treated under the following two options:

3.6.11.5.1 Simple risk-weight method: The RW shall be applied to the exposures (net of
specific provisions) based on equity exposures in the Islamic Banking book. The RW under simple risk weight method for equity position risk in respect of an equity exposure in a business venture shall entail a 400% RW for shares that are not publicly traded less any specific provisions for impairment. If there is a third party guarantee to make good impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.

3.6.11.5.2 Slotting method: The Licensee should map its RW into four categories as set out in the Article 4.7 on specialised financing.

3.6.12 Joint ownership of real estate and movable assets (such as cars) – Musharaka with Ijarah sub-contract:

3.6.12.1 Income producing Musharaka through leasing to third parties by means of Ijarah contracts exposes the capital contributor to the risk of that underlying Ijarah contract, i.e. counterparty risk mitigated by the value of leased assets.

3.6.12.2 This Musharaka investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the Central Bank, and 100% risk-weight on residual value of an Ijarah asset (operating lease). In case the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for Ijarah as set out in Article 3.5).

3.6.13 Musharaka with Murabaha sub-contract:

3.6.13.1 Income producing Musharaka through selling to third parties by means of Murabaha contracts exposes the capital contributor to the risk of that counterparty/buyer.

3.6.13.2 This Musharaka investment shall be assigned a RW based on the credit standing of the counterparty/buyer, as rated by an ECAI that is approved by the supervisory authority. In case the counterparty is unrated, a RW of 100% shall apply. (Please refer to the treatment for Murabaha as set out in Article 3.2.)

3.6.14 Diminishing Musharaka:

3.6.14.1 The equity exposure in a Diminishing Musharaka contract, where the Licensee intends to transfer its full ownership in movable assets and working capital to the other partner over the life of the contract, is calculated based on the remaining balance of the amount invested (measured at historical cost including any share of undistributed profits) less any specific provision for impairment. This exposure shall be risk weighted according to the nature of the underlying assets as set out in Articles 3.6.12 to 3.6.13. If there is a third party guarantee to make good
impairment losses, the RW of the guarantor shall be substituted for that of the assets for the amount of any such guarantee.

3.7 Mudaraba

3.7.1 This Article sets out the minimum capital adequacy requirement to cover the risk of losing invested capital arising from entering into contracts or transactions that are based on the Shari’a rules and principles of Mudaraba where the Licensee assumes the role of capital provider. This Article is applicable to both restricted and unrestricted Mudaraba financing.

3.7.2 A Mudaraba is an agreement between the Licensee and a customer whereby the Licensee would contribute capital to an enterprise or activity which is to be managed by the customer as the (labour provider or) Mudarib.

3.7.3 Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudaraba agreement whilst losses are to be borne solely by the Licensee unless the losses are due to the Mudarib’s misconduct, negligence or breach of contractual terms.

3.7.4 A Mudaraba financing can be carried out on either:

3.7.4.1 A restricted basis, where the capital provider allows the Mudarib to make investments subject to specified investment criteria or certain restrictions such as types of instrument, sector or country exposures; and

3.7.4.2 An unrestricted basis, where the capital provider allows the Mudarib to invest funds freely based on the latter’s skills and expertise.

3.7.5 As the fund provider, the Licensee is exposed to the risk of losing its capital investment or capital impairment risk upon making payment of the capital to the Mudarib. Any loss on the investment is to be borne solely by the capital provider, but is limited to the amount of his capital. Losses that are due to misconduct, negligence or breach of contractual terms are to be borne by the Mudarib.

3.7.6 However, while it is not permissible for a Mudarib to give a guarantee against such losses, such a guarantee may be given by a third party on the basis of Tabarru (donation). In such a case, the amount of the Mudaraba capital so guaranteed may be considered as subject to credit risk with a risk weighting equal to that of the guarantor.

3.7.7 In particular, such guarantees may be given when liquid funds are placed in an Islamic interbank market under a Mudaraba contract.
3.7.8 Equity Position Risk – Mudaraba

3.7.8.1 Mudaraba exposures, unless deducted for regulatory capital purposes (according to the framework consolidation / deduction subject in Article 2.7 and 2.8) are treated as an equity position. The capital calculation of these positions is illustrated below:

3.7.8.2 Exposures in private commercial enterprises undertaking trading activities in foreign exchange, shares or commodities.

3.7.8.2.1 The RW shall be based on the applicable underlying assets as set out in the Market Risk section in Article 6.2.

3.7.8.2.2 The investment in foreign exchange and trading in gold shall be measured according to the treatment as set out in Article 6.3, which requires 8% capital charge on the greater of either net long or net short positions and 8% capital charge on the net position of gold.

3.7.8.3 The RW of a Mudaraba that invests in quoted shares shall be measured according to the equity position risk approach where positions in assets tradable in markets qualify for treatment as equity position risk in the trading book, which would incur a total capital charge of 16% (equivalent to 200% RW) as set out in Market Risk Article 6.2. The capital charge can be reduced to 12% (equivalent to 150% RW) for a portfolio that is both liquid and well-diversified, subject to meeting the criteria as determined by the supervisory authorities.

3.7.8.4 Investment in commodities shall be measured according to either the maturity ladder approach or simplified approach as set out in Article 6.5.

3.7.8.5 Mudaraba exposures in the commercial enterprises other than in Article 3.7.8.2 can be treated under following two options:

3.7.8.5.1 Simple risk-weight method: The RW shall be applied to the exposures (net of specific provisions) based on equity exposures in the Islamic Banking book. The RW under simple risk weight method for equity position risk in respect of an equity exposure in a business venture should entail a 400% for shares that are not publicly traded less any specific provisions for impairment. However, funds invested on a Mudaraba basis may be subject to withdrawal by the investor at short notice, and in that case may be considered as being as liquid as shares that are publicly traded. The applicable RW in such a case is 300%.

3.7.8.5.2 Slotting method: The Licensee should map its RW into four categories as set out in Article 4.7.
3.7.8.6 The above RW under the slotting for specialised financing includes an additional fixed factor of 20% RW to cater for potential decline in the Mudaraba’s net asset value.

3.7.9 Mudaraba investment in project finance:

3.7.9.1 A Licensee may advance funds to a customer who acts as Mudarib in a construction contract for a third-party customer (ultimate customer). The ultimate customer makes progress payments to the Mudarib who in turn makes payments to the Licensee. The essential role of the Licensee in this structure is to provide bridging finance to the Mudarib pending its receipt of the progress payments. In this Mudarib structure:

3.7.9.1.1 The Licensee has no direct or contractual relationship with the ultimate customer (but the Licensee may stipulate that payments by the ultimate customer to the Mudarib be made to an account (“repayment account”) with the Licensee which has been opened for the purpose of the Mudaraba and from which the Mudarib may not make withdrawals without the Licensee’s permission); and

3.7.9.1.2 The Licensee as investor advances funds to the construction company as Mudarib for the construction project and is entitled to a share of the profit of the project but must bear 100% of any loss.

3.7.9.2 The Licensee is exposed to the risk on the amounts paid to the Mudarib, and as these amounts are made on a profit sharing and loss bearing basis they are treated under credit risk as “equity positions in the ‘banking book’”. In principle, the Licensee’s credit exposure is to the Mudarib, not to the ultimate customer; however, as described below, a structure may involve the “Mudaraba repayment account” instead of making payments to the Mudarib, which transfers much of the credit risk to the ultimate customer.

3.7.9.3 In addition to credit risk (i.e. that the Mudarib has received payment from the ultimate customer but fails to pay the Licensee, or that the ultimate customer fails to pay) the Licensee is exposed to capital impairment in case the project results in a loss. Direct payment should be made by the ultimate customer into account opened with the Licensee and effectively pledged to the Licensee.

3.7.9.4 Much of the Licensee’s credit exposure to the Mudarib may be transferred to the ultimate customer under this structure involving the “repayment account”. If the ultimate customer is a sovereign or otherwise has a very low risk weighting, this may affect the RW to be applied to the exposure, and other credit risk mitigants may be applied, as described below.

3.7.9.5 Provided the construction work proceeds normally and to the ultimate customer’s
satisfaction, the risk attached to the progress payments due from the ultimate customer to the Mudarib is the credit risk of the ultimate customer. However, this does not per se constitute a mitigation of the credit risk of the Licensee’s exposure to the Mudarib. In such a case, if an independent engineer employed to certify that the work has reached a certain stage of completion has issued a certificate to that effect, so that a progress payment is due from the ultimate customer, from the point of view of the Licensee the amount of that progress payment due is no longer exposed to the risk of unsatisfactory performance by the Mudarib, but only to the latter’s failure to pay the Licensee (the Mudarib being exposed to possible default by the ultimate customer). Such an amount might thus arguably bear a RW based entirely on the credit standing of the Mudarib, i.e. say 100%, rather than 400%. However, if a binding agreement exists between the Licensee and the ultimate customer whereby the latter makes the payment into a “repayment account” with the Licensee, the latter’s credit exposure in respect of the amount due is transferred from the Mudarib to the ultimate customer.

3.7.9.6 Other structures may be used which have the effect of modifying the risk exposures of the investors in a Mudaraba. The determination of the risk exposure (nature and amount) shall take into account any such structures and this will also be reflected in the application of RW.

3.7.9.7 The Licensee’s overall credit exposure in respect of the Mudaraba in such a case can be divided into three parts:

3.7.9.7.1 The amount receivable by the Licensee from the Mudarib in respect of progress payments due to the Mudarib from the ultimate customer for work certified as having reached a certain stage of completion. If a binding agreement exists as described in Article 3.7.9.1 whereby the amount is paid by the ultimate customer into a “repayment account” with the Licensee, a RW reflects the credit standing of the ultimate customer. In the absence of such an agreement, the RW would reflect the credit standing of the Mudarib or 100% for unrated.

3.7.9.7.2 The amount held in the “repayment account” with the Licensee, which would have a risk weighting of 0%;

3.7.9.7.3 Any remaining balance of the funds advanced by the Licensee to the Mudarib, which would incur a RW of 400% unless otherwise rated, the treatment as set out in Article 3.7.8.5.2 applies.

3.8 Sukuk Held as an Investment (in the Banking Book)

3.8.1 This Article sets out the minimum capital adequacy requirement to cover the credit risk
and market risk arising from the holding of Sukuk.

3.8.2 This Article is applicable only to Sukuk or certificates that represent the holder’s proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset (Asset-backed Sukuk). This Article does not cover certificates that give the holders the entitlement to receive returns on an asset of which the ownership is not transferred to the Sukuk holders (Asset-based Sukuk).

3.8.3 Sukuk can be broadly categorised into:

3.8.3.1 Asset-based Sukuk, where the underlying assets offer fairly predictable returns to the Sukuk holders, such as in the case of Salam, Istsina’a and Ijarah (Note: the assets in question may be held by a Musharaka or Mudaraba which is securitised. This is not the same as the Musharaka or Mudaraba Sukuk mentioned below).

3.8.3.2 Equity-based Sukuk, where the returns are determined on a profit and loss sharing basis in the underlying investment which does not offer fairly predictable returns (e.g. Musharaka or Mudaraba for trading purposes).

3.8.4 Central Bank has the discretion to specify measurement approaches as it deems appropriate for other types of Sukuk which are not listed in this Article, provided they are approved by a Shari’a Supervisory Board.

3.8.5 Salam Sukuk:

3.8.5.1 A Salam Sukuk represents fractional ownership of the capital of a Salam transaction, where the Salam capital is constituted by an advance payment to counterparty as supplier of a commodity (the subject-matter) to be delivered at a future date. This type of Sukuk is non-tradable, since the subject-matter is considered to be a financial asset (a receivable). The gross return to the Sukuk holders consists of the margin or spread between the purchase price of the subject-matter and its selling price following delivery. In certain Sukuk issues, a third party gives an undertaking that the subject-matter is sold at a price exceeding the purchase price by a specified margin. This may be achieved by means of a Parallel Salam transaction in which a third party purchases the subject-matter for delivery on the same delivery date as in the original Salam contract.

3.8.6 Istsina’a Sukuk:

3.8.7 An Istsina’a Sukuk represents a fractional share in the project financing of an undertaking to manufacture or construct an asset for a customer at a price to be paid in future instalments, the total of which equals the total face value of the Sukuk, in addition to mark-up. The Sukuk can be in the form of serial notes or certificates with different maturity dates that match the progress schedule of instalments as agreed between the
buyer/customer of the asset and the manufacturer/bank. Istisna’a Sukuk are tradable as the subject-matter is considered to be a non-financial asset (work-in-process inventory).

3.8.8 Ijarah Sukuk:

3.8.8.1 An Ijarah Sukuk represents the holder’s proportionate ownership in a leased asset where the Sukuk holders collectively assume the rights and obligations of the lessor. The Sukuk holder enjoys a share of the lease rental in proportion to the ownership share in the leased asset. An Ijarah Sukuk is tradable from the issuance date as the subject-matter is a non-financial asset owned by the Sukuk holders. As a part-owner, the Ijarah Sukuk holder assumes a proportionate share of any loss if the leased asset is destroyed or of the cost of meeting the obligation to provide an alternative asset, failing which, the lessee can terminate the lease without paying future rentals.

3.8.9 Musharaka Sukuk:

3.8.9.1 A Musharaka Sukuk represents the direct pro-rata ownership of the holder in the assets of a private commercial enterprise or a project where the subscription money is normally employed in purchasing non-liquid assets such as real estate or moveable assets. A Musharaka Sukuk is a profit and loss sharing instrument where the exposure is of the nature of an equity position in the Islamic Banking book, except in the case of investments (normally short-term) in assets for trading purposes. A Musharaka certificate can be tradable provided that non-cash and receivable assets are not less than 30% of market capitalisation.

3.8.10 Mudaraba Sukuk:

3.8.10.1 Sukuk holders subscribe to the certificates issued by a Mudarib and share the profit and bear any losses arising from the Mudaraba operations. The returns to the holders are dependent on the revenue generated by the underlying investment. The rule regarding tradability of the certificates is the same as for Musharaka certificates.

3.8.11 Capital treatment of Salam Sukuk:

3.8.11.1 The credit risk in Salam Sukuk is similar to that of the underlying Salam contract, where the credit risk exists upon the subscription of the Sukuk until the delivery and sale of the subject-matter. As such, the RW is based on the counterparty (Salam supplier) unless the Salam capital is guaranteed by a third party in which case the RW is that of the guarantor if lower than that of the supplier. The RW is 100% for an unrated counterparty (Salam supplier) or guarantor/third party when the Salam capital is guaranteed by the third party, if any.

3.8.11.2 The market risk in Salam Sukuk is likewise the same as that of the underlying
contract, namely a long position in the underlying commodity. This risk can be measured according to either the maturity ladder approach or the simplified approach as set out in Article 6.2.

3.8.11.3 A Salam Sukuk which is structured with an undertaking from the issuer that the underlying commodity is sold to a third party at a specified selling price (by means of a Parallel Salam contract) shall carry the RW of the buyer of that underlying commodity in the Parallel Salam contract.

3.8.12 Capital treatment of Istisna’a Sukuk:

3.8.12.1 In Istisna’a, the credit risk occurs upon commencement of the manufacturing or construction works by the Licensee until the whole amount or all the instalments (progress billings) are paid by the purchaser/issuer.

3.8.12.2 The RW for Istisna’a Sukuk is based on the counterparty/customer, which is 100% for an unrated buyer, unless a third party provides a guarantee in which case the third party’s RW (if lower than that of the counterparty) is applicable. In addition, a RW of 20% is added to cater for the price risk to which the underlying Istisna’a is exposed. In the case of ECAI-rated Istisna’a Sukuk, the ECAI rating applies.

3.8.12.3 In the event the returns to the Sukuk holder are from the cash flow of the underlying assets, which fall in the category of limited and non-recourse Istisna’a, the RW shall be based on the ‘Supervisory Slotting Criteria’ approach which carries RW of 70% to 250%.

3.8.12.4 Please refer to Article 3.4 on Istisna’a for a detailed treatment.

3.8.13 Capital treatment of Ijarah and IMB Sukuk:

3.8.13.1 The RW for IMB rentals is based on the lessee’s/counterparty risk since the residual value risk of the underlying asset is not borne by the Sukuk holders. Please refer to the Article 3.5 on Ijarah and IMB for a detailed treatment.

3.8.13.2 In the case of ECAI-rated Ijarah and IMB Sukuk, the ECAI rating applies.

3.8.14 Musharaka Sukuk:

3.8.15 The treatment of Musharaka Sukuk is based on the intent of the underlying investments in Musharaka that can be categorised into:

3.8.15.1 Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities.
3.8.15.1.1 The risk weights (RW) shall be based on the applicable underlying assets as set out in the Market Risk section in Article 6.

3.8.15.2 Private commercial enterprise to undertake business venture or project (other than 3.8.15.1)

3.8.15.2.1 The RW for equity position risk in respect of an equity exposure in a business venture or project is measured according to either the simple risk weight method or the supervisory slotting criteria approach. The treatment as set out herein is not applicable to a Musharaka/business venture that issues other types of Sukuk, such as an Ijarah Sukuk, of which provisions under the Ijarah Sukuk shall be applied.

3.8.15.3 Joint ownership of real estate or movable assets (such as cars):

3.8.15.3.1 Income producing Musharaka investments through leasing to third parties by means of Ijarah shall carry the RW of the counterparty, that is, the lessee.

3.8.15.3.2 Income producing Musharaka investments through selling to third parties by means of Murabaha shall carry the RW of the counterparty, that is, the buyer.

3.8.15.3.3 Please refer to Article on Musharaka for a detailed treatment.

3.8.16 Mudaraba Sukuk:

3.8.16.1 The treatment of Mudaraba Sukuk is based on the intent of the underlying investments in Mudaraba that can be categorised into:

3.8.16.2 Private commercial enterprise to undertake trading activities in foreign exchange, shares or commodities.

3.8.16.2.1 The RW shall be based on the applicable underlying assets as set out in the Market Risk section in the Article 6.2.

3.8.16.3 Private commercial enterprise to undertake business venture or project (other than 3.8.16.2).

3.8.16.3.1 The RW for equity position risk in respect of an equity exposure in a business venture or project is measured according to either the simple risk weight method or the supervisory slotting criteria approach.

3.8.16.3.2 Please refer to the Article on Mudaraba for detailed treatment.

3.8.16.4 In the case of ECAI rated Mudaraba Sukuk, the ECAI rating applies.

3.8.17 Exclusion:

3.8.17.1 A Sukuk which is issued by a sovereign shall carry the RW applicable to that
sovereign, according to its respective rating as assigned by an ECAI that is approved by the supervisory authority.
4. Credit Risk – The Standardised Approach

4.1 Introduction

4.1.1 Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murabaha contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisna’a contracts, lease payments receivable in Ijarah contracts and Sukuk held to maturity in the Islamic Banking book. Credit risk is measured according to the Standardised Approach as outlined in the Basel II guidelines, except for certain exposures arising from investments by means of Musharaka or Mudaraba contracts in assets in the Islamic Banking book. The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and risk-weighted using the methods proposed in Basel II either for “equity exposures in the Islamic Banking book” or at the supervisory slotting criteria for specialised financing.

4.1.2 The assignment of Risk Weights under the standardised approach takes into consideration the following:

4.1.2.1 The credit risk rating of an obligor or other counterparty, or a security, based on External Credit Assessment Institutions (ECAI) ratings.

4.1.2.2 Credit risk mitigation techniques adopted by the Licensees;

4.1.2.3 Types of the underlying assets that are sold and collateralised or leased by the Licensees; and

4.1.2.4 The amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.

4.1.3 In determining the risk weights under the Standardised Approach, Licensees should use the assessments by ECAIs, recognized as eligible for capital purposes by the Central Bank. The Central Bank shall determine whether the ECAIs meet the eligibility criteria specified under Article 4.3.3. Licensees may rely upon the ratings assigned by the recognized ECAIs for assigning risk weights for capital adequacy purposes and may be guided by the mapping of external ratings, as furnished in the guidelines. The mapping, as presented in the guidelines, shall be reviewed periodically and may be modified, if considered necessary, by the Central Bank.
4.2 Individual Claims

4.2.1 Claims on Sovereigns

4.2.1.1 The claims on the Government of the Sultanate of Oman and the Central Bank, which are denominated and funded in Rial Omani, shall be assigned a risk weight of 0%. Where the host country supervisors mandate 0% or preferential risk weights on the claims on their Sovereigns (or Central Banks) that are denominated and funded in their national currencies, Licensee could also assign preferential risk weights on such claims. The claims on the local government and other sovereigns including the central banks that are denominated and funded in currencies other than the respective national currencies are risk weighted as under:

<table>
<thead>
<tr>
<th>Credit Assessment of S &amp; P</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Assessment of Moody’s</td>
<td>Aaa to Aa-</td>
<td>A+ to A-</td>
<td>Baa+ to Baa-</td>
<td>Ba+ to B-</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of FITCH</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BBB-</td>
<td>BB+ to B</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of CI</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BBB-</td>
<td>BB+ to B</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Risk weight</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>

4.2.1.2 Licensees could also use the consensus country risk classification of OECD for assigning risk weights. The OECD risk scores, which are available on their website (www.oecd.org) in the Export Credit Arrangement web-page of the Trade Directorate correspond to the risk weight categories as detailed below:

<table>
<thead>
<tr>
<th>OECD Risk</th>
<th>0-1</th>
<th>2</th>
<th>3</th>
<th>4-6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk weight</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
</tr>
</tbody>
</table>
4.2.2 However, in case a host supervisor requires a more conservative treatment to the exposures in the books of foreign branches of domestic banks, they should adopt the requirements prescribed by the host country supervisors for assigning the risk weights.

4.2.3 Claims on Public Sector Entities (PSEs):

4.2.3.1 The PSEs in the Sultanate, irrespective of the shareholding pattern of the government, function as corporate in competitive markets. The claims on domestic public sector entities, therefore, should be risk weighted as applicable to corporate.

4.2.4 Claims on Multilateral Development Banks (MDBs):

4.2.4.1 The claims on highly rated MDBs - Bank for International Settlements, the International Monetary Fund, World Bank Group (International Bank for Reconstruction & Development and the International Finance Corporation), Asian Development Bank, African Development Bank, European Bank for Reconstruction & Development, Inter-American Development Bank, European Investment Bank, European Investment Fund, Nordic Investment Bank, Caribbean Development Bank, Islamic Development Bank and Council of Europe Development Bank, evaluated by the Basel Committee, shall be assigned 0% risk weight. The claims on other MDBs are based on external credit assessments, as set out for claims on banks but without the possibility of using preferential treatment for short-term claims.

4.2.5 Claims on Banks:

4.2.5.1 The claims on banks are risk weighted on the basis of the assessments of ECAIs, as indicated below:

<table>
<thead>
<tr>
<th>Credit Assessment of S &amp; P</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to B</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Assessment of Moody’s</td>
<td>AAA to Aa-</td>
<td>A+ to A-</td>
<td>Baa+ to Baa-</td>
<td>B + to B</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of FITCH</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BBB-</td>
<td>B+ to B</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of CI</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BBB-</td>
<td>B+ to B</td>
<td>Below B-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>50%</td>
</tr>
<tr>
<td>Risk weight for claims having an original</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>50%</td>
<td>150%</td>
<td>20%</td>
</tr>
</tbody>
</table>
4.2.6 No claim on an unrated bank should be risk weighted lower than that applied to claims of its sovereign of incorporation. However, a preferential risk weight that is one category more favourable should be applied to claims with an original maturity of three months or less, subject to a floor of 20%. Further, a risk weight that is one category less favourable than that assigned to claims on the sovereign, subject to a floor of 20%, should be assigned to claims on banks of an original maturity of three months or less and denominated and funded in the domestic currency. However, the preferential treatment should not be available to claims with original maturity under three months, which are expected to be rolled over (i.e. where implicit / explicit prior understanding exists for periodical rollover of the facilities implying that the effective maturity is longer than three months).

4.2.7 Claims on Securities Firms:

4.2.7.1 The claims on securities firms including finance and leasing companies should be treated as claims on corporate for the purpose of assigning risk weights.

4.2.8 Claims on Corporates:

4.2.8.1 The claims on corporates shall be risk weighted as per the assessments of approved ECAIs. The following table indicates the risk weight applicable to claims on corporates. The standard risk weight for unrated claims on a corporate should be 100%. However, no claims on an unrated corporate should be given a risk weight preferential to that assigned to its sovereign of incorporation.

<table>
<thead>
<tr>
<th>Credit Assessment of S &amp; P</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>Below BB-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Assessment of Moody’s</td>
<td>A a to Aa-</td>
<td>A+ to A-</td>
<td>Baa+ to Ba-</td>
<td>Below Ba-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of FITCH</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BB-</td>
<td>Below BB-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Credit Assessment of CI</td>
<td>AAA to AA-</td>
<td>A+ to A-</td>
<td>BBB+ to BB-</td>
<td>Below BB-</td>
<td>Unrated</td>
</tr>
<tr>
<td>Risk weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>
4.2.8.2 In the event of any adverse movement in the overall default experiences, the Central Bank, as part of the supervisory review process, may increase the standard risk weight to higher than 100% for unrated claims.

4.2.8.3 Licensees have the option, subject to prior approval from the Central Bank, to risk weight all claims on corporates at 100% without regard to external ratings. Where this option is exercised, the Licensees should apply only a single consistent approach - either to use ratings wherever available or not at all.

4.2.9 Claims included in the Regulatory Retail Portfolios:

4.2.9.1 Claims that qualify the following criteria shall be included in the retail portfolio for regulatory capital purposes.

4.2.9.1.1 Orientation criterion - the exposure is to an individual person or persons or to a small business. Small business is one where the aggregate exposure is less than RO 250,000.

4.2.9.1.2 Product criterion - the exposure takes the form of revolving credits and lines of credit (including credit cards and overdrafts), personal term financing and leases (e.g. auto finance and leases, student, educational and medical financing, personal finance) and small business facilities and commitments. Securities such as Sukuk and equities, whether listed or not, and mortgage financing that qualifies for treatment as claims secured by residential property are excluded from this category.

4.2.9.1.3 Granularity criterion - Licensees must ensure that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. Aggregate exposure to a customer and his related parties should not exceed 0.2% of the overall regulatory retail portfolio. Non Performing Assets (NPAs), under retail portfolio loans are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion for risk-weighting purposes.

4.2.9.1.4 Low value of individual exposures - The maximum aggregated retail exposure to a single obligor and his related parties should not exceed RO 250,000.

4.2.9.2 For assigning risk weights on regulatory retail portfolio, a two-track approach has been proposed. Considering the risk profile of the portfolio and the current default experiences, the portfolio should be assigned the following risk weights.

4.2.9.3 Retail financing, which complies with the following conditions, shall be assigned a concessional risk weight of 75%, except as provided in Article 4.2.12 for past
due assets:

4.2.9.3.1 Effective maturity not to exceed 84 months, including a maximum of two waivers per year.

4.2.9.3.2 Should provide top-ups only after payment of a minimum of 18 monthly installments.

4.2.9.3.3 Total debt burden not to exceed 65% of gross salary.

4.2.9.3.4 Aggregate exposure to a single counterparty should not exceed R0 50,000 or 0.2% of the regulatory retail portfolio.

4.2.9.4 All other retail financing including small business finance should be risk weighted at 100%. The position would be reviewed periodically and necessary adjustments to the risk weights would be made on the basis of the evolving situation.

4.2.9.5 For the purpose of ascertaining the size of the retail financing, exposure would mean sanctioned limit or the actual outstanding, whichever is higher, for all fund based and un-funded facilities, including all types of off-balance sheet items.

4.2.9.6 Aggregate exposure means gross amount (i.e. not taking any benefit of credit risk mitigation) of all forms of debt exposures (e.g. financing or commitments). In addition, ‘one counterpart’ or individual person or persons means one or several entities that may be considered as a single obligor.

4.2.10 Claims Secured by Residential Property:

4.2.10.1 Financing fully secured by mortgages on residential property with a maximum of two dwelling units in a single building or in a residential complex that is or will be occupied by the customer, or that is rented, shall be risk weighted at 35%. In applying the 35% risk weight, Licensees should ensure that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of at least 20% (maximum financing-to-value ratio of 80%) over the amount of the financing based on the extant valuation rules. Real estate shall be valued by a recognized / reputed estate agent within the last three years and the property legally mortgaged to the Licensee. In case the valuation report of the real estate securing the mortgage finance is more than three years old, the Licensee shall not apply the preferential risk weighting of 35% on such facility and instead apply 100% risk weight. Financing to value ratio of 80% shall be evaluated at the end of the each reporting period, with reference to the current market value as per the
valuation report and the current outstanding balance.

4.2.10.2 The Central Bank would review, as appropriate from time to time, the volatility in the prices and default experiences in the real estate market and might increase the standard risk weight when the prudential criteria are not met or where the default experience for claims secured by residential mortgages warrants a higher risk weight.

4.2.11 Claims Secured by Commercial Real Estate:

4.2.11.1 Claims secured by mortgages on commercial real estate should be risk weighted at 100%. The Central Bank would review, as appropriate from time to time, the volatility in the prices and default experiences in the real estate market and might increase the standard risk weight beyond 100%, if situation warrants.

4.2.12 Past Due Receivables - Non Performing Assets (NPA):

4.2.12.1 The unsecured portion of any financing (other than a qualifying residential mortgage financing) that is classified as NPA, net of specific provisions and reserve profit (including partial write-offs), should be risk-weighted as follows:

4.2.12.2 150% risk weight when specific provisions are less than 25% of the outstanding amount, net of reserve profit, of the financing.

4.2.12.3 100% risk weight when specific provisions are not less than 25% of the outstanding amount, net of reserve profit, of the financing.

4.2.12.4 The Licensees shall use the prudential norms, as set out in corresponding Article in Credit Risk Title for the risk classification. Risk classification should be undertaken customer-wise. Accordingly, for the purpose of computing the level of specific provisions on NPAs for deciding the risk-weighting, all funded and the credit equivalent of the unfunded and the current and potential exposures of other off-balance sheet exposures of a single counterparty should be aggregated.

4.2.12.5 For the purpose of defining the secured portion of the NPA, eligible collateral and guarantees will be the same as recognized for credit risk mitigation purposes in Article 4.4. Further, where a NPA is fully secured by mortgage of land and building, which are not recognized for credit risk mitigation purposes, a 100% risk weight may be applied where the valuation report is not more than three years old and the provisions reach 25% of the outstanding amount (net of reserve profits) of the financing. The real estate collaterals should be properly and legally mortgaged to the Licensee and are valued by recognized or reputed real estate agents. However, real estate as collateral is not recognized anywhere else under
the standardized approach.

4.2.12.6 Qualifying residential mortgage financing, which are NPAs, shall be risk weighted at 100%, net of specific provisions and reserve profits.

4.2.12.7 Licensees are permitted to treat non-past due receivables (other than NPAs) extended to counterparties subject to a risk weight of 150% in the same way as NPAs, as described in the Article 4.2.12.

4.2.13 High Risk Categories:

4.2.14 The following claims should be risk weighted at 150% or more:

4.2.14.1 Claims on Sovereigns and banks rated below B-;

4.2.14.2 Claims on corporates rated below BB-;

4.2.14.3 Real Estate and personal property acquired in satisfaction of financing previously contracted and Licensees have been carrying such assets for more than 12 months from the date of acquisition.

4.2.15 Further, Licensees should also assign 150% risk weight on venture capital and private equity investments (which are not rated investment grade by any of the recognized ECAIs). The Central Bank may, in due course, decide to apply 150% or higher risk weight reflecting the heightened risks associated with their exposures or claims that may be identified as high-risk exposures.

4.2.16 Other Assets:

4.2.16.1 Other assets will attract a uniform risk weight of 100%. However, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities should be treated as cash and assigned a risk weight of 0%. Further, cash items in the process of collection should be risk-weighted at 20%.

4.3 Off Balance Sheet Exposures

4.3.1 The credit risk exposure on off-balance sheet items should be converted into credit exposure equivalents through the use of Credit Conversion Factors (CCF). Accordingly, Licensees should use the CCF, as indicated below, with the exception of foreign exchange related items, which should then be multiplied by the risk weights attributable to the relevant counterparties.
<table>
<thead>
<tr>
<th>No.</th>
<th>Instruments</th>
<th>Credit Conversion Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Direct credit substitutes e.g. general guarantees of indebtedness (including standby LCs serving as financial guarantees for financing and securities) and acceptances (including endorsements with the character of acceptance).</td>
<td>100%</td>
</tr>
<tr>
<td>2</td>
<td>Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby LCs related to particular transactions).</td>
<td>50%</td>
</tr>
<tr>
<td>3</td>
<td>Short-term, self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments) for both issuing bank and confirming bank</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the Licensee.</td>
<td>100%</td>
</tr>
<tr>
<td>5</td>
<td>Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down.</td>
<td>100%</td>
</tr>
<tr>
<td>6</td>
<td>Lending of securities or posting of securities as collateral including instances where these arise out of repo style transactions.</td>
<td>100%</td>
</tr>
<tr>
<td>7</td>
<td>Note issuance facilities and revolving underwriting facilities.</td>
<td>50%</td>
</tr>
<tr>
<td>8</td>
<td>Commitments (e.g., formal standby facilities and credit lines) with an original maturity of over one year.</td>
<td>50%</td>
</tr>
<tr>
<td>9</td>
<td>Commitments with an original maturity up to one year.</td>
<td>20%</td>
</tr>
<tr>
<td>10</td>
<td>Commitments that are unconditionally cancellable at any time by the Licensee without prior notice or that effectively provide for automatic cancellation due to deterioration in a customer’s creditworthiness</td>
<td>0%</td>
</tr>
</tbody>
</table>

4.3.1.1 Where there is an undertaking to provide a commitment on an off-balance sheet item, Licensees should apply the lower of the two applicable CCFs.

4.3.2 Failed and unsettled transactions:

4.3.2.1 Licensees should develop and implement systems for tracking and monitoring the
credit risk exposures arising from unsettled and failed transactions. Transactions settled through Delivery-versus-Payment (DVP) systems expose Licensees to a risk of loss of positive current exposure. Transactions where cash is paid without receipt of the corresponding securities/currency/gold/commodities or vice versa expose Licensees to a risk of loss of the full amount of cash paid or deliverables delivered.

4.3.2.2 The following capital treatment is applicable to all transactions on securities, foreign exchange instruments and commodities that give rise to a risk of delayed settlement or delivery. This includes a transaction through a recognized clearing house that is subject to daily mark-to-market and payment of daily variation margins and that involves a mismatched trade. Further, delays and/or failure in settlement, in cases of systems wide failure of settlement or clearing systems, are waived from capital charge until the situation is rectified.

4.3.2.3 For DVP transactions, if the payments have not yet taken place within five business days after the settlement date, Licensees must calculate a capital charge by multiplying the positive current exposure of the transaction by the appropriate factor, according to the table below:

<table>
<thead>
<tr>
<th>No. of Working Days after the Agreed Settlement Date</th>
<th>Corresponding Risk Multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 5 to 15</td>
<td>8%</td>
</tr>
<tr>
<td>From 16 to 30</td>
<td>50%</td>
</tr>
<tr>
<td>From 31 to 45</td>
<td>75%</td>
</tr>
<tr>
<td>46 or more</td>
<td>100%</td>
</tr>
</tbody>
</table>

4.3.2.4 For non-DVP transactions, after the first contractual payment / delivery leg, the Licensee that has made the payment should treat its exposure as a financing, if the second leg has not been received by the end of the business day (if the dates when two payment legs are made are the same according to the time zones where each payment is made, it is deemed that they are settled on the same day) and assign risk weight according to the risk category of the counterparty. However, when the exposures are not material (i.e. under RO 100,000), Licensees have an option to assign a uniform risk weight of 100% in order to avoid the burden of a full credit risk assessment. If five business days after the second contractual payment/delivery date the second leg has not yet effectively taken place, the Licensee that has made the first payment leg should deduct from capital the full amount of the value transferred plus replacement cost, if any. This treatment
should be valid till the second payment/delivery leg is effectively made.

4.3.3 External Credit Assessments:

4.3.3.1 Eligible Credit Assessment Institutions (ECAsI):

4.3.3.2 The Central Bank will notify from time to time the eligible ECAI, on the basis of transparent parameters, whose credit assessments could be used by the Licensees for assigning risk weights for credit risk. In line with the provisions of Basel II, where the facility provided by the Licensee possesses rating assigned by any of the eligible ECAIs, the risk weight of the claim should be based on such rating. At present the following ECAIs are recognized by the Central Bank:

4.3.3.2.1 Standard & Poors;
4.3.3.2.2 Moody’s;
4.3.3.2.3 Fitch;
4.3.3.2.4 Capital Intelligence.

4.3.3.3 Scope of Application of External Assessments:

4.3.3.3.1 Licensees should use only the assessments of the recognized ECAIs consistently for each type of claim, for both risk weighting and risk management purposes. Licensees will not be allowed to “cherry-pick” the assessments provided by different ECAIs. Further, Licensees shall not use one ECAI’s rating for one exposure, while using another ECAI rating for another exposure to the same counterparty, unless the respective exposures are rated by only one of the recognized ECAIs whose ratings the Licensee has decided to use. External assessments for one entity within a corporate group should not be used to risk weight other entities within the same group.

4.3.3.3.2 Licensees must disclose the names of the ECAIs that they might use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by the Central Bank through the mapping process for each eligible ECAI as well as the aggregated risk weighted assets for each risk weight based on the assessment of each eligible ECAI. For assets in the Licensee’s portfolio that have contractual maturity of less than or equal to one year, short term ratings accorded by the eligible credit rating agencies shall be considered by the Licensee. For other assets which have a contractual maturity of more than one year, long term ratings accorded by the ECAIs would be relevant.
4.3.3.4 Mapping process

4.3.3.4.1 Basel II recommends development of a mapping process to assign the ratings issued by eligible ECAIs to the risk weights available under the Standardised risk weighting framework. The mapping process should result in a risk weight assignment consistent with that of the level of credit risk.

4.3.3.4.2 A mapping of the credit ratings awarded by the recognised ECAIs to the risk weight has been provided in the document at appropriate places for the Licensees to assign risk weights.

4.3.3.5 Short-term Ratings:

4.3.3.5.1 For risk-weighting purposes, short-term ratings are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalized to other short-term claims, except under the conditions mentioned in 4.3.3.8. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments should only be used for short-term claims against banks and corporates.

4.3.3.5.2 When Licensees generalize risk weight applicable to rated short term claims to other unrated short-term claims, subject to strict compliance with the provisions of 4.3.3.11, the following broad principles will apply.

4.3.3.5.3 The unrated short-term claim on counterparty will attract a risk weight of at least one level higher than the risk weight applicable to the rated claim. If a short-term rated facility attracts a 20% or a 50% risk-weight, unrated short-term claims cannot attract a risk weight lower than 50% or 100%, respectively.

4.3.3.5.4 Further, if an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-term, should also receive a 150% risk weight, unless the Licensee uses recognized credit risk mitigation techniques for such claims.

4.3.3.5.5 In respect of the short-term ratings the following mapping may be used:

<table>
<thead>
<tr>
<th>Short Term Rating</th>
<th>Rating Agencies</th>
<th>Risk Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard &amp; Poor’s or CI</td>
<td>Moody’s</td>
</tr>
<tr>
<td>A -1</td>
<td>P-1</td>
<td>F-1</td>
</tr>
<tr>
<td>A-2</td>
<td>P-2</td>
<td>F-2</td>
</tr>
<tr>
<td>A-3</td>
<td>P-3</td>
<td></td>
</tr>
</tbody>
</table>
Islamic Banking Regulatory Framework

<table>
<thead>
<tr>
<th>Short Term Rating</th>
<th>Risk Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Others</td>
<td>Others</td>
</tr>
</tbody>
</table>

4.3.3.6 Others include all non prime and B or C ratings.

4.3.3.7 The mappings (both long term and short term) would be reviewed periodically by the Central Bank.

4.3.3.8 When the Licensees assign preferential risk weights on short-term claims, as stated in Article 4.2.5, the interaction with specific short-term assessments is expected to be the following:

4.3.3.8.1 The general preferential treatment for short-term claims applies to all claims on Licensees of up to three months original maturity when there is no specific short-term claim assessment.

4.3.3.8.2 When there is a short-term assessment and such assessment maps into a risk weight that is more favourable or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. Other short-term claims would benefit from the general preferential treatment.

4.3.3.8.3 When a specific short-term assessment for a short-term claim on a bank maps into a less favourable (higher) risk weight, the general short-term preferential treatment for inter-bank claims should not be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessments.

4.3.3.9 Use of Unsolicited Ratings:

4.3.3.9.1 A rating would be treated as solicited only if the issuer of the instrument has requested the credit rating agency for the rating and has accepted the rating assigned by the agency. Licensees should use only solicited rating from the eligible ECAIs. No ratings issued by the credit rating agencies on an unsolicited basis should be considered for risk weight calculation as per the Standardized Approach.

4.3.3.10 Use of Multiple Assessments:

4.3.3.10.1 Licensees shall be guided by the following in respect of exposures / obligors having multiple ratings from the ECAIs chosen by the Licensee for the purpose of risk weight calculation:

4.3.3.10.2 If there were only one assessment by an eligible ECAI for a particular claim, that
assessment be used to determine the risk weight of the claim.

4.3.3.10.3 If there are two assessments accorded by ECAIs chosen by a Licensee, which map into different risk weights, the higher risk weight should be applied.

4.3.3.10.4 If there are three or more assessments accorded by eligible ECAIs with different risk weights, the ratings corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights should be applied.

4.3.3.11 Issuer versus Issues Assessment:

4.3.3.11.1 Where a Licensee invests in a particular issue that has an issue specific assessment, the risk weight of the claim should be based on this assessment. Where the Licensee’s claim is not an investment in a specific assessed issue, the following general principles should be applied:

4.3.3.11.1.1 In circumstances where the customer has a specific assessment for an issued financing - but the Licensee’s claim is not an investment in this particular financing - a high quality credit assessment (one which maps into a risk weight lower than that applies to an unrated claim) on that specific financing may be applied to the Licensee’s unassessed claim only if this claim ranks pari passu or senior to the specific rated financing in all respects. If not, the credit assessment cannot be used and the unassessed claim will receive the risk weight for unrated claims.

4.3.3.11.1.2 In circumstances where the customer has an issuer assessment, this typically applies to senior unsecured claims of that issuer. Accordingly, only senior claims in that issuer should benefit from a high quality issuer assessment. Other unassessed claims of such an issuer should be treated as unrated. If either the issuer or single issue has a low quality assessment (mapping into a risk weight equal to or higher than that which applies to unrated claims), an unassessed claim on the same counterparty will be assigned the same risk weight as is applicable to the low quality assessment.

4.3.3.11.1.3 Where a Licensee intends to extend an issuer or an issue specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure of the Licensee, i.e. both principal and profit.

4.3.3.11.1.4 With a view to avoiding any double counting of credit enhancement factors, no recognition of credit risk mitigation techniques should be taken into account if the credit enhancement is already reflected in the issue specific rating.
4.3.3.11.1.5 Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that customer, the general rule is that foreign currency ratings would be used only for exposures in foreign currency. Domestic currency ratings, if separate, would be used to risk weight only claims denominated in the domestic currency.

4.4 Credit Risk Mitigation

4.4.1 The exposure in respect of a customer, counterparty or other obligor can be further adjusted or reduced by taking into account the credit risk mitigation (CRM) techniques employed by the Licensee.

4.4.2 Licensees use a number of techniques or tools - collateral, guarantee, netting, etc. - to mitigate the credit risks to which they are exposed. Subject to complying with the conditions laid out in the guidelines, the approach to CRM allows a wider range of credit risk mitigants to be recognized.

4.4.3 The following general principles shall be followed by Licensee when using CRM techniques:

4.4.3.1 No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

4.4.3.2 The effects of CRM will not be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.

4.4.3.3 Principal-only ratings will not be allowed within the CRM framework.

4.4.3.4 While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase residual risks - legal, operational, liquidity and market risks. Therefore, it is imperative that Licensees employ robust procedures and processes to control these risks. Where these risks are not adequately controlled, the Central Bank may impose additional capital charges or take other supervisory actions under the Second Pillar.

4.4.3.5 The Third Pillar requirements must also be observed by Licensees to obtain capital relief in respect of any CRM techniques.

4.4.4 The CRM techniques that are commonly employed by the Licensees are as follows:

4.4.5 Hamish Jiddiyah (security deposit held as collateral)

4.4.5.1 Hamish Jiddiyah (HJ), a refundable security deposit taken by the Licensee prior to establishing a contract, carries a limited recourse to the extent of damages
incurred by the Licensee when the purchase orderer fails to honour a binding promise to purchase (PP) or promise to lease (PL). The Licensee has recourse to the client in the PP/PL if the HJ is insufficient to cover for the damages. However, only the actual loss can be recovered by the Licensee and not the opportunity cost. In the case of a non-binding PP/PL, the HJ shall be refunded in full to the clients, and hence is not considered as an eligible CRM.

4.4.6 Urbun (earnest money held after a contract is established as collateral to guarantee contract performance)

4.4.6.1 The Urbun taken from a purchaser or lessee when a contract is established accrues to the benefit of the Licensee if the purchaser or lessee breaches the contract within the agreed upon terms.

4.4.7 Guarantee from a Third Party (recourse or non-recourse guarantee)

4.4.7.1 The guarantor may or may not have recourse to the customer (i.e. purchaser or lessee) and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. However, a claim should first be made against the customer, and then against the guarantor, unless an option is provided to make the claim against either the customer or the guarantor.

4.4.7.2 The guarantee can also be given in a ‘blanket’ form that covers an unknown amount or a future receivable. However, this type of guarantee (sometimes known as a “market/business guarantee” or “guarantee of contractual obligation”) is revocable at any time prior to the existence of the future receivables and does not qualify as an eligible CRM.

4.4.7.3 Capital relief for the use of a guarantee shall be given when the following conditions are satisfied:

4.4.7.3.1 the guarantee represents the Licensee’s direct claim on the guarantor;

4.4.7.3.2 the guarantee is irrevocable and does not allow the guarantor to unilaterally cancel the guarantee after creation of the receivables;

4.4.7.3.3 the guarantee is unconditional and provides no protection clause that prevents the guarantor from being obliged to pay out in a timely manner in the event that the original counterparty fails to make payments due;

4.4.7.3.4 the Licensee has the right to pursue, in a timely manner, the guarantor for monies outstanding, rather than having to pursue the original counterparty to recover its
exposure;

4.4.7.3.5 the guarantee shall be an explicitly documented obligation assumed by the guarantor; and

4.4.7.3.6 the guarantee shall cover all types of expected payments made under the contract in the event that the original counterparty defaults.
4.4.8 Pledge of Assets as Collateral

4.4.8.1 The pledged asset must be a Shari’a compliant asset of monetary value that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance. The pledge must be legally enforceable. The asset pledged may either be the underlying asset or any other asset owned by the customer. The pledge of an asset owned by a third party is subject to the owner’s consent to the pledge.

4.4.8.2 The pledgor can authorise the Licensee, as the pledgee, to sell the asset and to offset the amount due against the sale proceeds without recourse to the courts. Alternatively, the Licensee can demand the sale of the pledged asset in order to recover the amount due. Any surplus from the sale proceeds is to be returned to the pledgor and any shortfall shall be treated as an unsecured exposure that ranks pari passu with other unsecured creditors when the customer / debtor is declared insolvent.

4.4.8.3 In case the Licensee takes collateral of an asset pledged more than once, the collateral of the Licensee shall be ranked either pari passu to the collaterals of other earlier pledgees with their consent, or junior to the earlier pledgees, in which case the Licensee’s claim shall be limited to the residual value of the pledged asset after payment is made to earlier pledgees. The Licensee shall take the residual value after deducting a haircut under the Simple Approach, the Standard Supervisory Haircuts or the Internal Haircut Approach to offset its credit exposure but should first ascertain the recoverability value of the asset after taking into consideration the Licensee’s position as a pledgee as to whether it ranks pari passu with the other pledgee(s) or ranks junior to a pledgee that is registered earlier than the Licensee.

4.4.9 Leased Assets

4.4.9.1 Assets leased under Ijarah or IMB contracts fulfil a function similar to that of collateral, in that they may be repossessed by the lessor in the event of default by the lessee.

4.4.9.2 The collateralisation under the concept of “Rahn” or “Kafalah” shall be properly documented in a security agreement or in the body of a contract to the extent permissible by Shari’a, and must be binding on all parties and legally enforceable in the relevant jurisdictions.

4.4.10 Legal Certainty
4.4.11 In order for the Licensees to obtain capital relief for any use of CRM techniques, certain minimum standards for legal documentation must be met. All documentation used in collateralized transactions must be binding on all parties and legally enforceable in all relevant jurisdictions. Licensees must have conducted sufficient legal review, which should be well documented, to verify this and have a well-founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents. Licensees should also undertake such further review as necessary to ensure continuing enforceability.

4.4.12 Overall Framework and Minimum Conditions

4.4.12.1 Licensees may opt for either the simple approach, which substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralized portion of the exposure (generally subject to a 20% floor), or for the standard supervisory haircuts approach which allows fuller offset of collateral against exposures by effectively reducing the exposure amount by the value ascribed to the collateral.

4.4.12.2 Licensees may operate under either, but not both, approaches. Licensees choosing to use comprehensive approach for recognizing collaterals in normal course should not revert to simple approach. Licensees in the Sultanate may adopt either of the approaches in the Islamic Banking book, but only comprehensive approach in the trading book. Partial collateralization is recognized in both approaches. Mismatches in the maturity of the underlying exposure and the collateral will only be allowed under the standard supervisory haircuts approach. However, before capital relief will be granted in respect of any form of collateral, the standards set out below must be met:

4.4.12.3 In addition to the general requirements for legal certainty, the legal mechanism by which collateral is pledged or transferred must ensure that the Licensee has the right to liquidate or take legal possession of it, in a timely manner, in the event of default, insolvency or bankruptcy (or one or more otherwise defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, Licensees must take all steps necessary to fulfil those requirements under the law applicable to the Licensee’s interest in the collateral for obtaining and maintaining an enforceable security, e.g. by registering it with a registrar for exercising a right to net or set off in relation to title of transferred collateral.

4.4.12.4 In order for collateral to provide protection, 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.

4.4.12.5 Licensees must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

4.4.12.6 Where the collateral is held by a custodian, Licensees must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

4.4.12.7 Capital requirement will be applied to a Licensee on either side of the collateralized transaction.

4.4.13 Types of Collateral

4.4.13.1 The types of collateral given below are eligible for relief in respect of the above CRM techniques.

4.4.13.2 Hamish Jiddiyah (security deposit) only for agreements to purchase or lease preceded by a binding promise.

4.4.13.3 Urbun

4.4.13.4 Profit sharing investment account or cash on deposit with the Licensee which is incurring the exposure

4.4.13.5 Sukuk rated by an external rating agency which is issued by:

4.4.13.5.1 Sovereigns and Public Sector Entities (PSEs) (treated as sovereigns) with a minimum rating of BB-; or

4.4.13.5.2 Issuers other than the above, with a minimum rating of BBB- or A-3 / P-3.

4.4.13.6 Sukuk that is unrated by an ECAI but fulfils each of the following criteria:

4.4.13.6.1 Issued by an Islamic Bank or a Conventional Bank or a sovereign;

4.4.13.6.2 Listed on a recognised exchange;

4.4.13.6.3 All other rated issues by the Licensee or conventional bank of the same seniority of at least BBB - or A-3/P-3 by a recognized ECAI, as determined by the Central Bank;

4.4.13.6.4 Classified as a Sukuk with a senior charge on the receivables;

4.4.13.6.5 The Licensee which incurs the exposure or is holding the collateral has no
information to suggest that the issue would justify a rating below BBB- or A-3/P-3; and

4.4.13.6.6 Licensees are sufficiently confident about the market liquidity of the securities.

4.4.13.7 Equities and units in collective investment schemes.

4.4.13.8 Guarantees issued by third parties that fall within the following categories:

4.4.13.8.1 Sovereigns and central banks;

4.4.13.8.2 PSEs;

4.4.13.8.3 MDBs;

4.4.13.8.4 International organizations / official entities with 0% RW

4.4.13.8.5 Islamic Banks or conventional banks; and

4.4.13.8.6 Corporate entities (including Takaful and securities firms) either by the parent, subsidiary and affiliates, of a minimum rating of A-.

4.4.13.9 Assets pledged as collateral as stated in Article 4.4.8 and Article 4.4.9

4.4.14 The Simple Approach

4.4.15 Under this approach, the risk weighting of the collateral instrument collateralizing or partially collateralizing the exposure will be substituted for the risk weighting of the counterparty. The adoption of this approach will be subject to the following conditions:

4.4.15.1 The collateral must be pledged for at least the life of the exposure and it must be marked to market and revalued with a minimum frequency of six months.

4.4.15.2 The portion of claims collateralized by the market value of recognized collateral receives the risk weight applicable to the collateral instrument.

4.4.15.3 The 20% floor for the risk weight on a collateralized transaction will not be applied and a 0% risk weight can be applied where the exposure and collateral are denominated in the same currency and either:

4.4.15.3.1 The collateral is cash on deposit, or

4.4.15.3.2 The collateral is sovereign security and its market value has been discounted by 20%.
4.4.15.4 The remainder of the claim should be assigned to the risk weight appropriate to the counterparty.

4.4.16 The Standard Supervisory Haircuts Approach

4.4.16.1 In this approach, when taking collateral, Licensees must calculate their adjusted exposure to a counterparty for capital adequacy purposes in order to take account of the effects of that collateral. Using haircuts, Licensees are required to adjust both the amount of the exposure to the counterparty and the value of any collateral received in support of that counterparty to take account of possible future fluctuations in the value by market movements. This will produce volatility adjusted amounts for both exposure and collateral. Unless either side of the transaction is cash, the volatility adjusted amount for the exposure will be higher than the exposure and for the collateral it will be lower.

4.4.16.2 Additionally, where the exposure and collateral are held in different currencies an additional downwards adjustment must be made to the volatility adjusted collateral amount to take account of possible future fluctuations in exchange rates.

4.4.16.3 Where the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount (including any further adjustment for foreign exchange risk), Licensees shall calculate their risk-weighted assets as the difference between the two multiplied by the risk weight of the counterparty. The framework for performing these calculations is set out in Articles 4.4.17 to 4.5.3.

4.4.16.4 Unless explicit approval is obtained from the Central Bank, Licensees must use standard supervisory haircuts given in Article 4.4.17.3.

4.4.17 Calculation of Capital Requirement Employing the Standard Supervisory Haircuts

4.4.17.1 For a collateralised transaction, the exposure amount after risk mitigation is calculated as follows:

\[ E^* = \max \{0, [E \times (1 + He) - C \times (1 - He - Hfx)]\} \]

where:

- \( E^* \) = the exposure value after risk mitigation
- \( E \) = current value of the exposure
- \( He \) = haircut appropriate to the exposure
C = the current value of the collateral received

Hc = haircut appropriate to the collateral

Hfx = haircut appropriate for currency mismatch between the collateral and exposure

4.4.17.2 The exposure amount after risk mitigation will be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralized transaction.

4.4.17.3 Both the amount of exposure to counterparty and the value of collateral received are adjusted by using standard supervisory haircuts as set out below:

<table>
<thead>
<tr>
<th>Types of Collateral</th>
<th>Residual Maturity</th>
<th>Haircuts (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Sovereigns</td>
</tr>
<tr>
<td>Cash</td>
<td>All</td>
<td>0</td>
</tr>
<tr>
<td>Sukuk</td>
<td>Long-term:</td>
<td></td>
</tr>
<tr>
<td>AAA to AA- and</td>
<td>≤ 1 year</td>
<td>0.5</td>
</tr>
<tr>
<td>Short-term: A-1</td>
<td>&gt; 1 Year to ≤ 5 Year</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>&gt; 5 Year</td>
<td>4</td>
</tr>
<tr>
<td>Sukuk</td>
<td>Long-term:</td>
<td></td>
</tr>
<tr>
<td>A+ to BBB- and</td>
<td>≤ 1</td>
<td>1</td>
</tr>
<tr>
<td>Short-term: A-2 to A-3 and unrated Bank Securities</td>
<td>&gt; 1 Year to ≤ 5 Year</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>&gt; 5 Year</td>
<td>6</td>
</tr>
<tr>
<td>Sukuk</td>
<td>Long-term:</td>
<td></td>
</tr>
<tr>
<td>BB+ to BB-</td>
<td>All</td>
<td>15</td>
</tr>
<tr>
<td>Sukuk (unrated)</td>
<td>All</td>
<td>25</td>
</tr>
<tr>
<td>Equities (included in main index)</td>
<td>All</td>
<td>50%</td>
</tr>
<tr>
<td>Equities</td>
<td>All</td>
<td>50%</td>
</tr>
</tbody>
</table>
### Types of Collateral

<table>
<thead>
<tr>
<th>Types of Collateral</th>
<th>Residual Maturity</th>
<th>Haircuts (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(not included in main index but listed)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Units in collective investment schemes</td>
<td>All</td>
<td>Highest haircut applicable to any security in which the fund can invest</td>
</tr>
<tr>
<td>Leased assets used as collateral (except residential real estate) and other assets</td>
<td>All</td>
<td>&gt;=30</td>
</tr>
</tbody>
</table>

4.4.17.4 The standard haircut for currency risk where exposure and collateral are denominated in different currencies is 8% (also based on a 10-business day holding period and daily mark-to-market).

### 4.5 Haircuts

4.5.1.1 There are basically two methods of calculating the haircuts: (i) standard supervisory haircuts, using parameters set by the Central Bank, and (ii) own-estimate haircuts, using Licensees’ own internal estimates of market price volatility. Till gaining experience and putting in place adequate systems, Licensees in the Sultanate are allowed to use only the standard supervisory haircuts for both the exposure as well as the collateral. However, Licensees which demonstrate sound systems to determine market price volatilities may be allowed to use their own estimates, subject to the Central Bank’s prior validation and approval.

4.5.1.2 The Standard Supervisory Haircuts (assuming daily mark-to-market, daily re-margining and a 10-business day holding period) expressed as percentages are as under:

4.5.1.3 The standard supervisory haircuts applicable to exposure / securities issued by the Government of the Sultanate will be the same as applicable to AAA rated debt
4.5.1.3.1 Sovereign will include the Central Bank, which is eligible for 0% risk weight.

4.5.1.3.2 The standard supervisory haircut for currency risk where exposure and collateral are denominated in different currencies is 8% (also based on a 10-business day holding period and daily mark-to-market)

4.5.1.3.3 Where the collateral is a basket of assets, the haircut on the basket will be $H = \sum a_i H_i$, where $a_i$ is the weight of the asset (as measured by units of currency) in the i basket and $H_i$ the haircut applicable to that asset.

4.5.1.3.4 The 10-business day holding period haircuts provided above will be the basis and this haircut will be scaled up or down depending on the type of transaction and the frequency of re-margining or revaluation using the formula below:

$$H = H_{10} \sqrt{\frac{N_T + (T_M - 1)}{10}},$$

where:

- $H$ = haircut
- $H_{10}$ = 10-business day standard supervisory haircut for instrument
- $N_T$ = actual number of business days between re-margining for capital market transactions or revaluation for secured transactions.
- $T_M$ = minimum holding period for the type of transaction

4.5.2 Own Estimate Haircuts

4.5.2.1 Subject to obtaining the approval from its supervisory authority, a Licensee may use its own estimate of haircuts to measure market price and foreign exchange volatilities. Such approval will normally require the fulfilling of certain qualitative and quantitative criteria set by the supervisory authority, inter-alia:

4.5.2.1.1 Integration of risk measures into daily risk management;

4.5.2.1.2 Validation of any significant change in the risk management process;

4.5.2.1.3 Verification of consistency, timeliness and reliability of data; and

4.5.2.1.4 Accuracy and appropriateness of volatility assumptions.
4.5.3 Maturity Mismatches

4.5.3.1 For the purposes of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of CRM is less than that of the underlying exposure.

4.5.3.2 The maturity of the underlying exposure and the maturity of the CRM should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period.

4.5.3.3 CRM with maturity mismatches are only recognised when their original maturities are greater than or equal to one year. As a result, the maturity of CRM for exposures with original maturities of less than one year must be matched to be recognised. In all cases, CRM with maturity mismatches will no longer be recognised when they have a residual maturity of three months or less.

4.5.3.4 When there is a maturity mismatch with recognised credit risk mitigants, the following adjustment will be applied.

\[
Pa = P \times \frac{(t - 0.25)}{(T - 0.25)},
\]

where:

- \(Pa\) = value of the credit protection adjusted for maturity mismatch
- \(P\) = credit protection (e.g. collateral amount, guarantee amount) adjusted for any haircuts
- \(t\) = \(\min(T, \text{residual maturity of the credit protection arrangement})\) expressed in years
- \(T\) = \(\min(5, \text{residual maturity of the exposure})\) expressed in years.
4.6 Credit Risk Mitigation for Mudaraba Classified as Equity Exposures

4.6.1 A placement of funds made under a Mudaraba contract may be subject to a Shari’a compliant guarantee from an independent third party. Such a guarantee relates only to the Mudaraba capital, not to the return. In such cases, the capital should be treated as subject to credit risk with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the Mudarib as counterparty. Otherwise, the RW of the Mudarib shall apply.

4.6.2 In Mudaraba investment in project finance, collateralisation of the progress payments made by the ultimate customers can be used to mitigate the exposures of unsatisfactory performance by the Mudarib.

4.6.3 The Licensee may also place liquid funds with the Central Bank or another bank on a short-term Mudaraba basis in order to obtain a return on those funds. Such placements serve as an interbank market with maturities ranging from an overnight market up to three months, but the funds may be withdrawn on demand before the maturity date in which case the return is calculated proportionately on the basis of duration and amount. Although from a juristic point of view the amounts so placed do not constitute debts, since (in the absence of misconduct or negligence) Mudaraba capital does not constitute a liability for the institution that acts as Mudarib, in practice the operation of this interbank market requires that the Mudarib should effectively treat them as liabilities. Hence a Licensee placing funds on this basis may treat them as cash equivalents and, for risk weighting purposes, apply the risk weight applicable to the Mudarib as counterparty.

4.7 Supervisory Slotting Criteria

4.7.1 Equity exposures in the nature of specialized financing will be risk-weighted as per the supervisory slotting criteria as detailed below. Specialized financing is basically a typical kind of exposure in which some special underlying assets are both the source of repayment and security. This may include financing extended to power plants, chemical processing plants, mines, transportation infrastructure, environment, telecommunications infrastructure, ships, aircraft, satellites, railcars, fleets, crude oil, metals, crops, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, hotels, high volatility real estate, etc.

4.7.2 A Licensee is required to map its RW into four supervisory categories as set out
in the Attachment 11.2 (specialised financing) for Limited and Non-Recourse Istisna’a exposures, Mudaraba exposures, Sukuk exposures and Musharaka in business venture exposures, where the RW for each category is as follows:

<table>
<thead>
<tr>
<th>Supervisory Category</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Credit Assessments</td>
<td>BBB- or better</td>
<td>BB+ or BB</td>
<td>BB- to B+</td>
<td>B to C-</td>
</tr>
<tr>
<td>Risk Weight</td>
<td>70%</td>
<td>90%</td>
<td>115%</td>
<td>250%</td>
</tr>
</tbody>
</table>

4.7.3 A Licensee with Diminishing Musharaka exposures in real estate is required to map its RW into the four supervisory categories as set out in Attachment 11.2 (Diminishing Musharaka in real estate) where the RW of each category is as follows:

<table>
<thead>
<tr>
<th>Supervisory Category</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Credit Assessments</td>
<td>BBB- or better</td>
<td>BB+ or BB</td>
<td>BB- to B+</td>
<td>B to C-</td>
</tr>
<tr>
<td>Risk Weight</td>
<td>90%</td>
<td>110%</td>
<td>135%</td>
<td>270%</td>
</tr>
</tbody>
</table>

4.7.4 The above RW under the slotting criteria for specialised financing include an additional fixed factor, equal to a 20% RW, to cater for the potential decline in the Musharaka net asset value.

4.7.5 If any exposure which is to be risk-weighted under this Article becomes past due, it will be risk-weighted at the higher of risk-weight applicable under 4.2.12 or the risk-weight applicable under this Article. For example, if an exposure getting 90% risk-weight as per the above becomes past due, it will be risk-weighted at 100% or 150% whichever is applicable. However, if an exposure getting 250% risk-weight under 4.4.15 above becomes past due, it will continue to be risk-weighted at 250%.

4.7.6 Interbank Mudaraba and Interbank Musharaka exposures should also be mapped to one of the four categories. Such exposures are subject to a special risk weight treatment compared to other Mudaraba and Musharaka investments as set out below:

<table>
<thead>
<tr>
<th>Supervisory Category</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Credit</td>
<td>BBB- or better</td>
<td>BB+ or BB or (Unrated)</td>
<td>BB- to B+</td>
<td>B to C-</td>
</tr>
</tbody>
</table>
### Supervisory Category

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk Weight</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
</tr>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
</tr>
<tr>
<td>when the</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>original</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>maturity is</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>less than 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>months</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4.7.7 The Central Bank shall review the credit quality of the Interbank exposures periodically. On the basis of such review, the risk weights may be revised in due course.
5. Sukuk and Securitization

5.1 Introduction

5.1.1 This Article deals with regulatory capital requirements for a Licensee in respect of Sukuk that are not covered in the Article 3.8. These aspects are the following:

5.1.1.1 Capital requirements for the Licensees that are holders of Sukuk that do not meet the criteria set out in Article 3.8.2, that is, they do not represent the holder’s proportional ownership in an undivided part of an underlying asset (or pool of assets) where the holder assumes all rights and obligations attaching to such an asset or pool of assets, so that the requirements of Article 3.8 do not apply.

5.1.1.2 The capital treatment of the exposures of a Licensee where it is, or acts in a capacity such that it is considered to be, the originator of a Sukuk issue, or as an issuer or servicer of a Sukuk issuance – that is, securitisation exposures. Essentially, this part of the Article deals with the conditions that need to be met in order for securitisation exposures to be de-recognised or minimised, and with the capital treatment of such exposures by the Licensee when they occur.

5.1.1.3 This Article applies to both originating and issuing Licensee (including originating Licensee that invests in its own originated Sukuk). For Sukuk that are traded in the secondary market, the market risk capital requirement as mentioned in Article 6.2 is applicable.

5.1.2 Definition of Sukuk

5.1.2.1 Sukuk (plural of Sakk), frequently referred to as “Islamic bonds”, are certificates with each Sakk representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a Mudaraba). These assets may be in a specific project or investment activity in accordance with Shari’a rules and principles.

5.1.3 Sukuk differ from conventional interest-based securities or bonds in a number of ways, including:

5.1.3.1 The funds raised through the issuance of Sukuk should be applied to investment in specified assets rather than for general unspecified purposes. This implies that identifiable assets should provide the basis for Sukuk.

5.1.3.2 Since the Sukuk are based on real underlying assets, income from Sukuk must be related to the purpose for which the funding is used.

5.1.3.3 The Sukuk certificate represents a proportionate ownership right over the assets in which the funds are being invested. The ownership rights are transferred, for a fixed period ending with the maturity date of the Sukuk, from the original owner (the originator) to the Sukuk holders.
5.1.4 Securitisation in Sukuk is broadly referred to as a process of issuing Sukuk involving the following steps:

5.1.4.1 Origination of assets (in conventional finance, these are normally loans or other receivables, while in Islamic finance these are Shari’a-compliant assets such as the subject matter of an Ijarah);

5.1.4.2 Transfer of the assets to a special purpose vehicle (SPV) which acts as the issuer by packaging them into securities (Sukuk); and

5.1.4.3 Issuing the securities to investors.

5.2 Sukuk Structures

5.2.1 Sukuk may take any one of the following structures:

5.2.1.1 An asset-backed Sukuk structure that meets the requirements of an asset-backed Sukuk as assessed by a recognised External Credit Assessment Institution (ECAI): This structure would leave the holders of Sukuk to bear any losses in case of the impairment of the assets. The applicable risks are those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI.

5.2.1.2 An asset-based Sukuk structure with a repurchase undertaking (binding promise) by the originator: The issuer purchases the assets, leases them on behalf of the investors and issues the Sukuk. Normally, the assets are leased back to the originator in a sale-and-leaseback transaction. The applicable credit risk is that of the originator, subject to any Shari’a-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer. Such structures are sometimes referred to as “pay-through” structures, since the income from the assets is paid to the investors through the issuer.

5.2.1.3 A so-called “pass-through” asset-based Sukuk structure: A separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the Sukuk. This issuing entity requires the originator to give the holders recourse, but provides Shari’a-compliant credit enhancement by guaranteeing repayment in case of default by the originator.

5.2.2 In conventional securitisations, the structure is normally such that the originator transfers the beneficial rights in or title to the assets to the issuer on behalf of the investors, who do not hold such rights directly but have beneficial ownership through their legal relationship to the issuer. The issuer is a SPV, which should be “bankruptcy remote” from the originator in order to protect the rights of the investors in case of the insolvency of the originator.
5.2.3 The Sukuk structures described in 5.2.1.2 and 5.2.1.3 are not explicitly covered in Article 3.8.

5.2.4 For Sukuk holders the applicable risk weights of structures in Article 5.2.1.2 and 5.2.1.3 above, where the issuance is likely to be exclusively supported by that of the originator through a repurchase undertaking, are the credit risk weight of the originator, subject to any Shari’a compliant credit enhancement by the issuer. The applicable credit risk weights are based on credit ratings issued by a recognised ECAI.

5.2.5 Sukuk structure with a repurchase undertaking (binding promise):

5.2.5.1 In this structure, the originator enters into a repurchase undertaking (binding promise to buy the assets), according to which the assets are repurchased by the originator at maturity or upon early termination if the originator has the option to call the Sukuk. Such structures are often used in the case of Ijarah (sale and leaseback) Sukuk issues. Where a repurchase undertaking exists, investors have a credit exposure to the corporate or sovereign entity providing the undertaking, and an analysis of the exposure of the underlying assets becomes secondary. This gives rise to the risks of (a) the enforceability or strength of the repurchase undertaking in the jurisdiction, and (b) the ranking or priority of the Sukuk in the capital structure of the originator. The term “pay through” is used for this type of structure when the income from the securitised assets is paid to the issuer, who passes it on to the investors (less any commission due to the issuer).

5.2.5.2 A commonly used Sukuk structure with a repurchase undertaking is the sovereign Sukuk issued by certain national monetary authorities. Both Ijarah-based (tradable) and Salam-based (non-tradable) Sukuk have been issued using such a structure, with a repurchase undertaking from the national monetary authority. In such a structure, the credit risk of the Sukuk is that of the originator. When the latter is a highly rated sovereign, the Sukuk benefit from an investment-grade credit rating; however, achieving such a rating may be problematic for a private-sector originator.

5.2.5.3 A Musharaka structure may be used that aims at replicating asset ownership by setting up a venture (Musharaka) jointly owned by the Sukuk issuer (usually incorporated as a SPV) and the originator. The issuer’s and the originator’s shareholdings in the Musharaka represent their respective capital contributions based on a parity agreed at the outset, usually comprised of: (a) capital from the issuer (for example, proceeds of the investors’ payment for the Sukuk); and (b) specific assets and “management skills” from the originator. Should the cash flows generated by the assets under the business plan of the Musharaka not be sufficient to fund these payments, subject to Shari’a permissibility, the issuer may have the option to call the repurchase undertaking on behalf of the investors.

5.2.6 Pass-through structure with no repurchase undertaking:
5.2.6.1 This is a structure involving asset-based Sukuk where a separate entity may act as sponsor and issuer by purchasing the underlying assets from the originator (that is, a financial institution), packaging them into a pool and securitising the pool by issuing the Sukuk. This sponsoring entity requires the originator to give the holders recourse, but provides Shari’a-compliant credit enhancement by guaranteeing repayment in case of default by the originator. This credit enhancement provides the Sukuk issuance with the credit rating of the (highly rated) issuer and thus enables it to achieve an investment-grade credit rating.

5.3 Parties in a Securitisation Structure

5.3.1 The parties in a securitisation structure include the originator, the issuer and the investors, in addition to which the following may be involved: one or more credit rating agencies to rate the securities (Sukuk), an investment banker to act as an adviser or to place the securities with investors, and (in conventional securitisations) an institution that acts as a provider of credit enhancement.

5.3.2 A Licensee may act as originator of Sukuk issues in any of the following cases:

5.3.2.1 The ownership of assets held by the Licensee is transferred to holders of Sukuk by means of securitisation. Such a securitisation may offer the Licensee one or more of the following benefits:

5.3.2.1.1 Increased liquidity, since a relatively illiquid asset (such as an asset held as lessor in an Ijarah or IMB) is converted into cash paid by the investors in the Sukuk; and

5.3.2.1.2 Reduced capital requirements, insofar as the securitisation may permit the Licensee to exclude the assets from the calculation of its risk-weighted assets since they are de-recognised, subject to any securitisation exposures. The achievement of the second of these benefits will depend on the way in which the securitisation is structured. For this, the Licensee must be able to de-recognise all or most of the exposures relating to the assets from its balance sheet, according to the criteria for de-recognition set out in Article 5.5.2.

5.3.2.2 A Licensee may act as sponsor of an asset-backed Sukuk issuance or similar program involving assets of a customer in which the Licensee manages or acts as adviser to the program, places the Sukuk into the market, or provides liquidity and/or credit enhancements. In this case, the benefit to the Licensee would be the earning of fees from the services provided.

5.3.3 In a securitisation structure, the role of servicer consists of collecting payments on behalf of the investors and passing them onto the latter, when this function is not carried out by the issuer. In the case of Ijarah or IMB assets, the lessor is legally responsible for maintaining the assets in such
condition that the lessee is not deprived of the full usufruct of the assets, which involves responsibility for basic maintenance, insurance/Takaful and so forth.

5.4 **Licensees’ Exposure to Risks from Various Perspectives**

5.4.1 *A Licensee may act in various capacities in a Sukuk securitisation. The risk exposures of Sukuk from various perspectives are summarised in the table below.*

<table>
<thead>
<tr>
<th>Originator</th>
<th>Servicer</th>
<th>Issuer</th>
<th>SPV</th>
<th>Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risks related to repurchase undertaking (binding promise)</strong></td>
<td>Service default</td>
<td>Default</td>
<td>Bankruptcy</td>
<td>Liquidity</td>
</tr>
<tr>
<td>The originator is obligated to make payments in respect of the Sukuk or the assets in certain circumstances resulting from a breach of certain representations and warranties. The originator may need to compensate the issuer in the equivalent amount or replace the relevant assets.</td>
<td>Where the underlying assets are consumer linked, there is still a dependence on the originator despite the fact that they have been sold to the Sukuk SPV. The originator usually maintains the business relationship with the underlying consumers and continues to collect payments on behalf of the Sukuk holders. In this capacity, the originator is referred to as a “servicer” and, despite satisfaction of all the regular securitization conditions, a default of a servicer would still have an adverse effect on the Sukuk performance.</td>
<td>If the originator fails to pay the coupon payments, the Sukuk holders (or the SPV on their behalf) can declare an event of default and accelerate the principal payment obligation of the originator by compelling the originator to repurchase the asset. If the originator fails to pay the principal amount equal to the Sukuk issue amount at the maturity of the lease term, the Sukuk holders (or the SPV on their behalf) will have a right to take legal action against the originator. The Sukuk holders (or the SPV on their behalf) may also</td>
<td>SPV is generally incorporated as a bankruptcy remote vehicle to mitigate bankruptcy risk.</td>
<td>The Sukuk holder will be subject to liquidity risk associated with the market, whether in the primary or secondary market.</td>
</tr>
<tr>
<td><strong>Settlement</strong></td>
<td></td>
<td></td>
<td></td>
<td>Rate of return</td>
</tr>
<tr>
<td>To avoid any settlement risk in relation to the SPV, all payments due from the obligor will be paid by the obligor directly to the clearinghouse, if any, which will then settle the payments directly to the Sukuk holders.</td>
<td></td>
<td></td>
<td>If the underlying rentals are fixed, then Licensee holding the Sukuk will be exposed to rate of return risk since their IAH are expecting returns reflecting a floating rate benchmark. The issuer may exercise a cleanup call, and the holders of the Sukuk being cancelled may not make the return they are expecting.</td>
<td>Impairment of assets</td>
</tr>
</tbody>
</table>
### 5.5 Operational Requirements Pertaining to Sukuk and Securitisation

5.5.1 Assets in securitisation

5.5.1.1 The assets in securitisation have to be Shari’a compliant.

5.5.1.2 The underlying assets to be securitised may include, inter alia, Ijarah assets, Murabaha or Salam receivables, Istimna’a assets or equity ownership (Musharaka or Mudaraba) according to Shari’a rules and principles. Assets that do not meet Shari’a criteria for tradability (being receivables) can be combined in a portfolio with Ijarah assets and/or with Musharaka or Mudaraba instruments that are classed as non-financial.

5.5.1.3 Non tradable financial assets may be combined in a pool with non-financial assets that can act as a basis for tradable Sukuk, provided the proportion of non-financial assets (neither debt nor cash) in the pool is not less than a certain acceptable minimum ratio, in accordance with Shari’a rules and principles.

5.5.1.4 Business ventures organised as Musharaka or Mudaraba partnerships may also be securitised, and the resultant Sukuk are tradable.

5.5.2 Recognition of risk transference (asset de-recognition criteria)

5.5.2.1 Licensees should meet the following condition for excluding the assets in which case one can exclude capital calculation for the assets under a Sukuk structure:

5.5.2.1.1 Substantially all credit risks (and price risk, where applicable) associated with the securitised assets have been transferred to third parties.

5.5.2.1.2 The transferor (that is, originator) does not maintain effective or indirect control over the underlying assets.

---

<table>
<thead>
<tr>
<th>Originator</th>
<th>Servicer</th>
<th>Issuer</th>
<th>SPV</th>
<th>Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>have the right to sell or foreclose on the underlying assets.</td>
<td></td>
<td>Depending on the structure, the holders of Sukuk bear any losses in case of the impairment of the underlying assets, in the absence of negligence of the lessee.</td>
</tr>
</tbody>
</table>
transferred assets.

5.5.2.1.3 The assets are legally isolated from the transferor in such a way that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership.

5.5.2.1.4 These conditions must be supported by an opinion provided by qualified legal counsel. The securitised assets held by the issuer will not be consolidated with the assets of the originator or the issuer’s parent in a bankruptcy or insolvency of any of those entities.

5.5.2.1.5 Holders of the Sukuk (investors) have a claim only to the underlying pool of assets, and have no claim against the transferor. Hence, assets in non-ABS (Asset Backed Securities) structures (pay-through and pass-through structures, as described in Article 5.2 above), would not qualify for de-recognition.

5.5.2.1.6 The immediate transferee is a SPV, and the holders of the beneficial interests in that entity have the right to pledge or exchange such interests without restriction.

5.5.2.1.7 Clean-up calls must be at the discretion of the originating Licensee. They must not be structured to provide credit enhancement and must be exercisable only when 10% or less of the purchase consideration for the underlying assets (for example, in an IMB) remains to be paid. If a clean-up call does not meet these conditions, it will be treated as a credit enhancement by the originator and gives rise to a capital charge accordingly.

5.5.2.1.8 Licensees meeting these conditions must still hold regulatory capital against any exposures that they retain in respect of the securitisation (such as credit enhancements).
5.5.2.2 In order to comply with Shari’a rules and principles, the structure must transfer all ownership rights in the assets from the originator via the issuer to the investors. Depending on the applicable legal system, these ownership rights do not necessarily include registered title. The transfer could be a simple collection of ownership attributes that allow the investor (a) to step into the shoes of the originator and (b) to perform (perhaps via a servicer) duties related to ownership. The transfer could also include rights granting access to the assets, subject to notice, and, in case of default, the right to take possession of the assets.

5.5.2.3 For the purpose of tax, accounting and/or regulation, the de-recognition of the assets from the originator’s balance sheet relies on a “true sale”, meaning that the economic value of assets has been transferred from one party to another in a way that prevents the creditors or liquidator of the seller from claiming the assets from the buyer, thus creating “bankruptcy remoteness” for the assets.

5.5.2.4 From a Shari’a perspective, subject to jurists’ interpretations in the jurisdiction, there are four key criteria for a transaction to be considered as a “true sale” that transfers beneficial title:

5.5.2.4.1 The transfer must be such that it cannot be recharacterised by a court or other body as a secured financing, or otherwise be avoided in a bankruptcy or insolvency proceeding involving the originator of the assets (such as pursuant to a fraudulent transfer in anticipation of bankruptcy or a preference payment).

5.5.2.4.2 The bankruptcy or insolvency of the originator should not affect the assets that have been transferred to the issuer / SPV. This, in turn, means that the issuer will be able to enforce collection and other rights against the source of the income (the payer) without hindrances resulting from the bankruptcy or insolvency of the originator.

5.5.2.4.3 The transfer must then be perfectible at the election of the issuer.

5.5.2.4.4 The sale must be free and clear of all prior overriding liens.

5.5.2.5 In the case of bankruptcy remoteness, subject to the legal framework in Oman, the conditions include the following:

5.5.2.5.1 If there were a bankruptcy of the issuer, the assets of the issuer would be distributed in accordance with law or a court order, rather than in accordance with the contractual arrangements involving the issuer.

5.5.2.5.2 Separateness covenants will be required to ensure bankruptcy remoteness (as well as non-
5.5.2.5.3 Another provision to ensure bankruptcy remoteness relates to non-competition and bankruptcy declarations. The originator, investors, credit enhancers and others agree in the transaction documents not to initiate involuntary bankruptcy proceedings against the issuer. The issuer should also provide, in both its constitutive documents and the transaction documents, not to initiate voluntary bankruptcy proceedings. The parties should seek a legal opinion from jurists in the jurisdiction concerned and ensure that these types of agreements and warranties are legally valid and enforceable.

5.5.3 Collateral security structure

5.5.3.1 Consideration of the collateral security structure is a critical factor; it needs to be the subject of legal opinions and is subject to Shari’a permissibility (in the case of perfectibility). Those security interests must be the first priority (there can be no prior or subsequent claims) and perfected (or perfectible).

5.5.3.2 The legal opinions must address the nature of the security interest, the enforceability of the security interest against third parties, and perfection requirements (such as notices and registration). The effects of bankruptcy on perfection must also be considered and opined upon.

5.6 Treatment for Regulatory Capital Purposes of Sukuk and Securitisation Exposures

5.6.1 Risk weights as set out in the Title on Capital Adequacy are applicable to a Licensee.

5.6.2 The application of risk weight shall depend on the extent to which the exposures or obligations attaching to the underlying assets have been effectively transferred to the Sukuk holders.

5.6.3 Capital requirements for Licensees as originators

5.6.3.1 Licensees as originators are required to hold regulatory capital against all of their retained securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in ABS originated by them, and extension of a liquidity facility or credit enhancement.

5.6.3.2 Repurchased securitisation exposures must be treated as retained securitisation exposures.

5.6.3.3 The risk-weighted asset amount of a securitisation exposure is computed by multiplying the
amount of the exposure by the appropriate risk weight. For off-balance sheet exposures, Licensees must apply a credit conversion factor (CCF) and then risk-weight the resultant credit equivalent amount. Please refer to Article 4.3.

5.6.3.4 Below are the credit risk weights for the retained securitisation exposures where the Licensee is the originator:

<table>
<thead>
<tr>
<th>Risk Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rating</td>
</tr>
<tr>
<td>Risk Weight</td>
</tr>
</tbody>
</table>

5.6.3.5 When an originator provides implicit support to a securitisation, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. The existence of this implicit support restricts the derecognition of the underlying assets for capital purposes.

5.6.3.6 An implicit support could not be met out of IAH funds without the consent of the IAH, as this would constitute misconduct and negligence and would give rise to other issues. This would also be true of any other implicit support that is not Shari’a compliant. In this context, the Licensee is required to disclose publicly (a) that it has provided non-contractual support and (b) the capital impact of doing so.

5.6.4 Treatment of liquidity facilities

5.6.4.1 The liquidity facilities in certain types of Sukuk structures are commitments from the facility provider to lend to or purchase assets from third parties if funds are needed to repay maturing Sukuk. The need for such facilities may result from a timing mismatch between cash collections of the underlying Sukuk assets and the scheduled payments (such as Ijarah rental) under the program to its holders.

5.6.4.2 Liquidity facilities should comply with Shari’a rules and principles and meet operational requirements set by the SSB of each Licensee. The requirements should include requiring the facility documentation to identify clearly and limit the circumstances under which it
may be drawn. Subject to meeting such requirements, the risk weight for liquidity facilities having a maturity of less than one year is set at 20% CCF, while that for facilities with maturities exceeding one year is set at 50% CCF. However, if an external rating of the facility itself is used for risk-weighting the facility, a 100% CCF must be applied.

5.6.4.3 A servicer cash advance, based on Qard (interest free loan), is an advance granted by the servicer to the SPV to ensure timely payment to the investors – for instance, in cases of timing differences between collection and payments. Such facilities should remain essentially separate from the Sukuk undertaking and this separation should be properly documented. In such cases of servicer cash advances, the Licensee may assign a risk weight of 0% to such facilities.

5.6.5 Treatment of credit risk mitigation for securitisation exposures

5.6.6 The treatment applies to a Licensee that has obtained a credit risk mitigant to a securitization exposure. Credit risk mitigants include guarantees, collateral and on-balance sheet netting or any other Shari’a-compliant credit risk mitigation as recognised by the regulatory authority. Collateral in this context is used to mitigate the credit risk of a securitisation exposure, rather than the underlying exposures of the securitisation transaction, subject to fulfilling the criteria in Article 5.5.3 above.

5.6.7 Eligible collateral is limited to that recognised under the standardised approach for credit risk mitigation (Article 4.4). Collateral pledged by SPVs is also recognised.

5.6.8 Treatment of credit enhancement provided by an issuer or originator

5.6.8.1 For Sukuk with credit enhancement provided by the issuer or the originator, the risk weight is based on the credit rating of the credit enhancer.

5.6.8.2 If the originator de-recognised the percentage of the asset that was securitised, the residual equity share retained by originator should be deducted from its capital.

5.6.8.3 Subject to Shari’a approval of the structure, an originator may retain a small equity share in a pool of securitised assets in order to provide over-collateralisation. For example, the originator of a securitisation of a pool of Ijarah assets might securitise 90% of the pool and retain 10% as an equity position (first loss position) – that is, a residual claim. The Sukuk holders would be entitled to income based on 90%, and the originator based on the remaining 10% of the rental income from the pool. However, if the rental income falls below the expected level, the shortfall would be made good to the extent of the originator’s first loss position based on a Hiba (donation) agreement.
5.6.9 Treatment of credit enhancement provided by a structure

5.6.9.1 In a Shari’a compliant credit enhancement structure (for example, as described above), the different components in the structure would be risk-weighted, as shown below:

<table>
<thead>
<tr>
<th>Rating</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>B+ and below</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>

5.6.9.2 When a Licensee is required to deduct a securitisation exposure from its capital, the deduction must be taken 50% from Tier 1 and 50% from Tier 2. Deductions from capital may be calculated net of any specific provisions taken against the relevant securitisation exposures.
6. **Capital Charge for Market Risk**

6.1 **Introduction**

6.1.1 *Market risk is defined as the risk of losses in on and off-balance sheet positions arising from movements in market prices.*

6.1.2 The market risk positions subject to capital charge requirement are:

6.1.2.1 Equity position risk in the trading book, and market risk on trading positions in Sukuk;

6.1.2.2 Foreign exchange risk; and

6.1.2.3 Commodities and inventory risk.

6.1.3 *Definition of the Trading Book*

6.1.4 *Banks’ balance sheets are broadly segmented into banking book and trading book. A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital measurements, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.*

6.1.5 *Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include, for example, proprietary positions, positions arising from client servicing (e.g. matched principal broking) and market making. Positions that are intended to be held for a term not exceeding 180 days (which may be reduced over a period) would be treated as part of trading book, subject to fulfilling other conditions.*

6.1.6 The following will be the basic requirements for positions eligible to receive trading book capital treatment:

6.1.6.1 Clearly documented trading strategy for the position/instrument or portfolios, approved by senior management (which would include expected holding horizon).

6.1.6.2 Clearly defined policies and procedures for the active management of the position, which must include:

6.1.6.2.1 Positions are managed on a trading desk;

6.1.6.2.2 Position limits, maximum maturity, holding period, duration, stop loss, rating standards, etc. are set and monitored for appropriateness;
6.1.6.2.3 Dealers have the autonomy to enter into/manage the position within agreed limits and according to the agreed strategy;

6.1.6.2.4 Positions are marked to market at least daily and when marking to model the parameters must be assessed on a daily basis;

6.1.6.2.5 Positions are reported to senior management as an integral part of the institution’s risk management process; and

6.1.6.2.6 Positions are actively monitored with reference to market information sources (assessment should be made of the market liquidity or the ability to hedge positions or the portfolio risk profiles). This would include assessing the quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market, etc.

6.1.7 Clearly defined policy and procedures to monitor the positions against the Licensee’s trading strategy including the monitoring of turnover and stale positions in the Licensee’s trading book.

6.1.8 In addition, for the limited purpose of assigning capital charge for market risk, financial assets, which are designated as at fair value through profit or loss, other than the trading book financial assets, would be considered as part of the trading book.

6.1.9 Capital charge for market risk is applicable to Licensees on a global consolidated basis. The capital charges for equities/Sukuk will apply to the current market value of the security in Licensees’ trading books. The capital charges for foreign exchange risk and commodities risk will apply to Licensees’ total currency and commodity positions, subject to some discretion to exclude structural foreign exchange positions. Licensees are required to manage the market risk in their books on an ongoing basis and ensure that the capital requirements for market risk are being maintained on a continuous basis, i.e. at the close of each business day.

6.1.10 In measuring the market risk a choice between two broad methodologies viz. Standardised and Internal Model based (described in Parts A and B of the paper issued by the Basel Committee) have been indicated by the Basel Committee. Considering the present risk management practices, Licensees are required to compute the capital charge in a standardized manner, using the measurement frameworks described in the guidelines.

6.1.11 The alternative methodology, which is subject to the fulfilment of certain conditions and the use of which is therefore conditional upon the explicit approval of the Central Bank, is set out in “Part B - Use of Internal Models to Measure Market Risks” as given in the Basel Committee document ‘Amendment to the Capital Accord to incorporate Market Risks’ (January 1996 as updated to
November 2005). This method allows Licensees to use risk measures derived from their own internal risk management models, subject to the following conditions:

6.1.11.1 Certain general criteria concerning the adequacy of the risk management system.
6.1.11.2 Qualitative standards for internal oversight of the use of models, notably by the management.
6.1.11.3 Guidelines for specifying an appropriate set of market risk factors (i.e. the market rates and prices that affect the value of Licensees’ positions).
6.1.11.4 Quantitative standards setting out the use of common minimum statistical parameters for measuring risk.
6.1.11.5 Guidelines for stress testing.
6.1.11.6 Validation procedures for external oversight of the use of models.
6.1.12 Licensees desirous of following the internal models approach may seek the Central Bank’s prior approval after establishing such advanced risk measurement systems. As a general guideline, it is expected that the Licensees which are in a position to move over to advanced approaches under Basel II only may move over to advanced methodologies in measuring the capital charge for market risk on the basis of internal models approach.

6.1.13 Each Licensee shall monitor and report the level of risk against which a capital requirement is to be applied.

6.1.14 All transactions, including forward sales and purchases, shall be included in the calculation of capital requirements as from the date on which they were entered into. Although regular reporting will, in principle, take place only at quarterly intervals (March, June, September and December), Licensees are expected to manage the market risk in their trading book in such a way that the capital requirements are being met on a continuous basis, i.e. at the close of each business day. Further, Licensees are also expected to maintain effective risk management systems to ensure that the intra-day exposures are not excessive.

6.1.15 Calculation of the Capital Ratio

6.1.15.1 In order to ensure consistency in the calculation of the capital requirements for credit and market risks, an explicit numerical link will be created by multiplying the measure of market risk by 12.5 (i.e. the reciprocal of the Basel defined minimum capital ratio of 8%) and adding the resulting figure to the sum of risk-weighted assets compiled for credit risk and operational risk purposes.

6.1.15.2 The ratio will then be calculated in relation to the sum of the three, using eligible capital as
the numerator.

6.1.15.3 It is assumed that the capital charge computed by the standardized method is sufficient only to meet the unexpected losses under a capital requirement of 8% and hence the capital charge has been scaled up to reflect the higher minimum capital adequacy requirements mandated in the Sultanate of Oman for credit risk.

6.2 Measurement of Capital Charge for Equities / Sukuk

6.2.1 Specific Risk

6.2.2 The capital charge for specific risk is 8% on all long equity positions and must be calculated on a market by market basis (for each national market). The capital charge can be reduced to 4% for a portfolio that is both liquid and well diversified, subject to criteria determined by the supervisory authorities.

6.2.3 General Market Risk

6.2.4 The capital charge for general market risk is 8% on all long equity positions. These positions must be calculated on a market by market basis (for each national market).

6.2.5 In the case of Sukuk in the trading book, the provision for specific risk charge will depend on the RW of the issue and the term to maturity of the Sukuk, as follows:

<table>
<thead>
<tr>
<th>Categories</th>
<th>External Credit Assessment</th>
<th>Specific Risk Capital Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign (Central Banks)</td>
<td>AAA to AA-</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>A+ to BBB-</td>
<td>0.25% (residual term to final maturity 6 months or less) 1.00% (residual term to final maturity 6 and 24 months) 1.60% (residual term to final maturity exceeding 24 months)</td>
</tr>
<tr>
<td></td>
<td>BB+ to B-</td>
<td>8%</td>
</tr>
<tr>
<td>Quantifying</td>
<td></td>
<td>0.25% (residual term to final maturity 6 months or less) 1.00% (residual term to final maturity 6 and 24 months) 1.60% (residual term to final maturity exceeding 24 months)</td>
</tr>
<tr>
<td>Others</td>
<td>BB+ to BB-</td>
<td>8%</td>
</tr>
<tr>
<td></td>
<td>Below BB-</td>
<td>12%</td>
</tr>
</tbody>
</table>
Categories | External Credit Assessment | Specific Risk Capital Charge
---|---|---
Unrated |  | 8%

6.2.6 General market risk is computed based on the two methods being the Maturity Method and the Duration method as discussed below. However, the Licensees are encouraged to use the Duration method for the same.

6.2.7 The provision for general market risk will depend on the residual term to maturity or to the next re-pricing date, using a simplified form of the Maturity Method on the net positions in each time-band in accordance with the table below:

<table>
<thead>
<tr>
<th>Residual term to maturity</th>
<th>RW</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 month or less</td>
<td>0.00%</td>
</tr>
<tr>
<td>1-3 months</td>
<td>0.20%</td>
</tr>
<tr>
<td>3-6 months</td>
<td>0.40%</td>
</tr>
<tr>
<td>6-12 months</td>
<td>0.70%</td>
</tr>
<tr>
<td>1-2 years</td>
<td>1.25%</td>
</tr>
<tr>
<td>2-3 years</td>
<td>1.75%</td>
</tr>
<tr>
<td>3-4 years</td>
<td>2.25%</td>
</tr>
<tr>
<td>4-5 years</td>
<td>2.75%</td>
</tr>
<tr>
<td>5-7 years</td>
<td>3.25%</td>
</tr>
<tr>
<td>7-10 years</td>
<td>3.75%</td>
</tr>
<tr>
<td>10-15 years</td>
<td>4.50%</td>
</tr>
<tr>
<td>15-20 years</td>
<td>5.25%</td>
</tr>
<tr>
<td>&gt;20 years</td>
<td>6.00%</td>
</tr>
</tbody>
</table>
6.2.8 As “duration” method is a more accurate method of measuring rate of return risk, it has been decided to adopt standardized duration method to arrive at the capital charge for the Licensees operating in the Sultanate. Accordingly, the Licensees are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately. Under this method, the mechanics are as follows:

6.2.8.1 First calculate the price sensitivity (modified duration) of each financial transaction.

6.2.8.2 Next apply the assumed change in yield to the modified duration of each instrument between 0.6 and 1.0 percentage points depending on the maturity of the instrument (fixed rate instruments on the basis of the residual term to maturity and floating rate instruments according to the residual term to the next re-pricing date).

6.2.8.3 Slot the resulting sensitivity measures into a maturity ladder with the fifteen time bands as set out in Table 1 below.

6.2.8.4 Subject long and short positions in each time band to a 5 percent vertical disallowance designed to capture basis risk.

6.2.8.5 Carry forward the net positions in each time-band for horizontal offsetting subject to the disallowances set out in Table 2 below.

Table 1 - Duration Method: Time-Bands and Assumed Changes in Yield

<table>
<thead>
<tr>
<th>Time Bands</th>
<th>Assumed Changes in Yield</th>
<th>Time Bands</th>
<th>Assumed Changes in Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zone 1</td>
<td></td>
<td>Zone 3</td>
<td></td>
</tr>
<tr>
<td>1 month or less</td>
<td>1.00</td>
<td>3.6 to 4.3 years</td>
<td>0.75</td>
</tr>
<tr>
<td>1 to 3 months</td>
<td>1.00</td>
<td>4.3 to 5.7 years</td>
<td>0.70</td>
</tr>
<tr>
<td>3 to 6 months</td>
<td>1.00</td>
<td>5.7 to 7.3 years</td>
<td>0.65</td>
</tr>
<tr>
<td>6 to 12 months</td>
<td>1.00</td>
<td>7.3 to 9.3 years</td>
<td>0.60</td>
</tr>
<tr>
<td>Zone 2</td>
<td></td>
<td>10.6 to 12 years</td>
<td>0.60</td>
</tr>
<tr>
<td>1.0 to 1.9 years</td>
<td>0.90</td>
<td>12 to 20 years</td>
<td>0.60</td>
</tr>
<tr>
<td>1.9 to 2.8 years</td>
<td>0.80</td>
<td>over 20 years</td>
<td>0.60</td>
</tr>
<tr>
<td>2.8 to 3.6 years</td>
<td>0.75</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2 - Horizontal Disallowances

<table>
<thead>
<tr>
<th>Zones</th>
<th>Time Band</th>
<th>Within the Zones</th>
<th>Between Adjacent Zones</th>
<th>Between Zones 1 and 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zones</td>
<td>Time Band</td>
<td>Within the Zones</td>
<td>Between Adjacent Zones</td>
<td>Between Zones 1 and 3</td>
</tr>
<tr>
<td>---------</td>
<td>--------------------------------</td>
<td>------------------</td>
<td>------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>Zone 1</td>
<td>1 month or less</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1 to 3 months</td>
<td>40%</td>
<td></td>
<td>40%</td>
</tr>
<tr>
<td></td>
<td>3 to 6 months</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>6 to 12 months</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1 to 2 years</td>
<td>40%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zone 2</td>
<td>2 to 3 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3 to 4 years</td>
<td>30%</td>
<td>40%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>4 to 5 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5 to 7 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zone 3</td>
<td>7 to 10 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>10 to 15 years</td>
<td>30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>15 to 20 years</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Over 20 years</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6.2.9 In the case of equity investments made by means of a Musharaka or a Mudaraba contract where the underlying assets are commodities, the market risk provisions for commodities, as described below, will be applicable.

6.3 **Measurement of Capital Charge for Foreign Exchange Risk**

6.3.1 For the purpose of capital charge, foreign currency position would be arrived at by considering the sum of the net short positions or the sum of the net long positions, in various currencies, whichever is greater. While calculating the net short or long positions, currency-wise, Licensees should also include the assigned capital at overseas branches. However, significant investments made in associates, joint ventures, etc. that are deducted from the Licensee’s capital need not be reckoned. Capital charge would be computed on the three-month average of sum of the net short positions or net long positions whichever is higher. The average is to be worked out on the basis of actual positions as obtained on all the working days during the immediately preceding three-month period from the reporting date.

6.3.2 The open position in gold would be arrived at separately. Capital charge for foreign exchange and gold open position would be computed at 8% at present, to reflect the general market risk. (See example below)

<table>
<thead>
<tr>
<th></th>
<th>USD</th>
<th>Euro</th>
<th>GBP</th>
<th>Yen</th>
<th>INR</th>
<th>PKR</th>
<th>Gold</th>
</tr>
</thead>
</table>

---

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The capital charge would be 8% of the higher of either the net long currency position or the net short currency position (i.e. 500) and of the net position in gold (100) = 500 + 100 = 600 x 8% = 48.

**6.4  Measuring the Foreign Exchange Risk in a Portfolio**

6.4.1 The Licensees are allowed to use either a Shorthand Method or Internal Models Approach in calculating the risks inherent in the Licensees’ mix of long and short positions in different currencies.

6.4.2 Central Bank recommends the Shorthand Method for the Licensees. The method is stated below:

6.4.2.1 Convert the nominal amount of the net position (net long or net short positions) in each foreign currency and in gold into the reporting currency using spot rates.

6.4.2.2 Aggregate the sum of converted net short positions or the sum of converted net long positions.

6.4.2.3 The greater sum of net short positions or net long positions calculated as above is added to the net position of gold/silver, to derive at the overall net position.

6.4.2.4 The capital charge is 8% on the overall net position as calculated above.

6.4.3 The use of an Internal Models Approach by a Licensee is subject to the Central Bank’s explicit approval and fulfilment of qualitative standards, specifications of market risk factors being captured into the Licensees’ risk management system, quantitative standards, comprehensive stress testing program and validation of the models by external auditors and/or supervisory authorities.

**6.5  Measurement of Capital Charge For Commodities Risk**

6.5.1 *Minimum capital standard described here under cover the risk of holding or taking positions in commodities, including precious metals, but excluding gold and silver (which are treated as a foreign currency according to the methodology set out in the Article on Foreign Currency Risk, as well as the inventory risk which results from the Licensee holding assets with a view to re-selling or*
leasing them.

6.5.2 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.

6.5.3 Inventory risk is defined as arising from holding items in inventory either for resale under a Murabaha contract or with a view to leasing under an Ijarah contract.

6.5.4 The price risk in commodities is often more complex and volatile than that associated with currencies and equities. Commodity markets may also be less liquid than those for other traded products and, as a result, changes in supply and demand can have a more dramatic effect on price and volatility. These market characteristics can make price transparency and the effective hedging of commodities risk more difficult.

6.5.5 There are three alternatives - models, maturity ladder and simplified approaches for measuring commodities / inventory position risk. However, Licensees are required to follow the simplified approach for the commodity and inventory risk. Licensees desirous of following any other method should approach the Central Bank for prior authorization.

6.5.6 Under all approaches, each commodity position is expressed in terms of the standard unit of quantitative measurement of weight or volume (barrels, kilos, grams, etc.). The net position in each commodity will then be converted at current spot rates into the reporting currency.

6.5.7 Positions in different groups of commodities cannot be offset unless:

6.5.7.1 The sub-categories of commodities are deliverable against each other;

6.5.7.2 The commodities represent close substitutes for each other; and

6.5.7.3 A minimum correlation of 0.9 between the price movements of the commodities can be clearly established over a minimum period of 1 year to the satisfaction of the supervisory authority.

6.5.8 Netting of positions for different commodities is subject to the supervisory authorities’ approval. Under the maturity ladder approach, the net positions are entered into seven time-bands as set out below:
<table>
<thead>
<tr>
<th>Time-band</th>
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<tbody>
<tr>
<td>1) 0 – 1 month</td>
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<td>2) 1 – 3 months</td>
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<tr>
<td>3) 3 – 6 months</td>
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<tr>
<td>4) 6 – 12 months</td>
</tr>
<tr>
<td>5) 1 – 2 years</td>
</tr>
<tr>
<td>6) 2 – 3 years</td>
</tr>
<tr>
<td>7) Over 3 years</td>
</tr>
</tbody>
</table>

6.5.9 A separate maturity ladder shall be used for each type of commodities.

6.5.10 All the physical stocks shall be allocated to the first time-band.

6.5.11 The calculation of capital charge is made in the following three steps:

6.5.11.1 The sum of short and long positions that are matched will be multiplied by the spot price for the commodity and then by the appropriate spread rate of 1.5% for each time band.

6.5.11.2 The residual or unmatched net positions from nearer time bands may be carried forward to offset exposures in a more distant time-band, subject to a surcharge of 0.6% of the net position carried forward in respect of each time-band that the net position is carried forward.

6.5.11.3 Any net position at the end of the carrying forward and offsetting will attract a capital charge of 15%.

6.5.12 The summation of the above three capital charges represents the total capital charge for commodities risk based on the maturity ladder approach.

6.5.13 Under the simplified approach as applied to commodities, the net position, long or short, in each commodity requires a capital charge of 15% to cater for directional risk plus an additional capital charge of 3% of the gross positions, i.e. long plus short positions, to cater for basis risk. The capital charge of 15% applies to assets held by the Licensees in inventory with a view to resale or lease.

6.5.14 For Istisna’a work-in-process (WIP), WIP inventory belonging to the Licensee shall attract a capital charge of 8% (equivalent to a 100% RW). In the case of the balance of unbilled WIP inventory under Istisna’a without Parallel Istisna’a, in addition to the RW for credit risk a capital charge of 1.6% is applied (equivalent to a 20% RW) to cater for market risk.
exposure.

6.5.15 The funding of a commodities position that exposes the Licensee to foreign exchange exposure is also subject to capital charge as measured under the foreign exchange risk.
## 7. Operational Risk

### 7.1 Capital Charge for Operational Risk

#### 7.1.1 Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people and systems or from external events, which includes but is not limited to, legal risk and Shari’a compliance risk. This definition excludes strategic and reputational risks. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

#### 7.1.2 Shari’a compliance risk is a type of operational risk facing the Licensee which can lead to non-recognition of income and resultant losses.

#### 7.1.3 Licensees are required to follow either the Basic Indicator Approach or the Standardised Approach as set out in Basel II for measurement of capital to cater to the operational risk.

#### 7.1.4 Under the Basic Indicator Approach, a fixed percentage of 15% of annual average positive gross income, averaged over the previous three years, is set aside.

#### 7.1.5 The capital charge may be expressed as follows:

\[
KBIA = \left( \frac{\sum (GI_{1}...n} \times \alpha}{n} \right)
\]

where

- \( KBIA \) = the capital charge under the Basic Indicator Approach
- \( GI \) = annual gross income, where positive, over the previous three years
- \( n \) = number of the previous three years for which gross income is positive
- \( \alpha = 15\% \), which is set by the Basel Committee, relating the industry wide level of required capital to the industry wide level of the indicator.

#### 7.1.6 Gross income is defined as:

- Net income from financing activities which is gross of any provisions and operating expenses and of depreciation of Ijarah assets;
- Add: Net income from investment activities; and
- Add: Fee income (e.g. commission and agency fee)
- Less: Investment account holders’ share of income
- The gross income includes income attributable to restricted and unrestricted Profit Sharing Investment Accounts’ funds, but excludes extraordinary or exceptional income. Net income from investment activities includes the Licensees’ share of profit from Musharaka and
Mudaraba financing activities.

7.1.7 Under the Standardised Approach, this percentage varies according to the line of business (LOB) from 12% to 18%, being 18% for corporate finance, trading and sales, and payment and settlement, to 15% for commercial banking and agency services, and 12% for retail banking, asset management and retail brokerage.

7.1.8 As the LOBs into which Licensees are organized are different from the above, it is proposed that, at the present stage, the Basic Indicator Approach be used, which requires the setting aside of a fixed percentage of average positive annual gross income over the previous three years.
8. Pillar 2 - Supervisory Review Process

8.1 Introduction

8.1.1 The objective of the Supervisory Review Process (SRP) is to ensure that the Licensees have adequate capital to support all the risks in their business as also to encourage them to develop and use better risk management techniques for monitoring and managing their risks. This in turn would require a well-defined internal assessment process (christened as Internal Capital Adequacy Assessment Process or ICAAP) within Licensees through which they assure the Central Bank that adequate capital is indeed held towards the various risks to which they are exposed. The process of assurance could also involve an active dialogue between the Licensee and the Central Bank so that, when warranted, appropriate intervention could be made to reduce the risk exposure of the Licensee or augment / restore its capital. Thus, ICAAP is an important component of the SRP.

8.1.2 ICAAP processes under the SRP should include:

8.1.2.1 The risks that are not fully captured by the minimum capital ratio prescribed under Pillar 1;

8.1.2.2 The risks that are not at all taken into account by the Pillar 1; and

8.1.2.3 The factors external to the Licensee.

8.1.3 Since the capital adequacy ratio prescribed by the Central Bank under the Pillar 1 of the Framework is only the regulatory minimum level, addressing only the three specified risks (viz. credit, market and operational risks), holding additional capital might be necessary for Licensees, on account of both – the possibility of some under-estimation of risks under the Pillar 1 and the actual risk exposure of a Licensee vis-à-vis the quality of its risk management architecture. Illustratively, some of the risks that the Licensees in the Sultanate are generally exposed to but which are not captured or not fully captured in the BIS Capital Adequacy Ratio would include:

8.1.3.1 Rate of return risk in the Islamic Banking book;

8.1.3.2 Credit concentration risk;

8.1.3.3 Liquidity risk;

8.1.3.4 Settlement risk;

8.1.3.5 Reputational risk;

8.1.3.6 Business and Strategic risk;

8.1.3.7 Risk of under-estimation of credit risk under the Standardised approach;
8.1.3.8 Risk of weakness in the credit-risk mitigants;

8.1.3.9 Factors external to the Licensee (like business cycle effects)

8.1.3.10 Country and transfer risk

8.1.4 Licensees should estimate the Pillar 2 risk like rate of return risk, credit concentration risk and liquidity risk. It is recognised that there is no one single approach for conducting the ICAAP and the market consensus in regard to the best practice for undertaking ICAAP is yet to emerge. The methodologies and techniques are still evolving particularly in regard to measurement of non-quantifiable risks, such as reputational and strategic risks. These guidelines, therefore, seek to provide only broad principles to be followed by Licensees in developing their ICAAP.

8.1.5 The ICAAP will be operationalised by all the Licensees in the Sultanate with effect from December 31, 2012. The Licensees may, however, commence ICAAP on a trial basis from December 31, 2011. Based on the outcome of the ICAAP as submitted to and approved by the Board, the ICAAP Document, in the format enclosed in Attachment 11.3, should be furnished to the Senior Manager, Banking Surveillance Department, CPOC Unit, Central Bank of Oman (with copies to Banking Examination Department and Banking Development Department).

8.1.6 The document should reach the Central Bank latest by end of the first quarter (January-March) of the relevant financial year. Although it is a joint responsibility, Licensees should inform the Central Bank of the details of the officials/department/s dealing with this for clarity of role and responsibility and contact convenience. However, the Licensees may build appropriate risk management architecture gradually to handle its risk universe covered under the ICAAP.

8.1.7 The ICAAP will be subject to review during the on-site examination process every year. The observations of on-site examination would be considered for estimating the appropriateness of the capital held by the Licensee during approval of annual draft audited financials. Also, there shall be review by the Central Bank (in examination/SREP) of the efficiency/effectiveness of the past years’ exercises.

8.1.8 Licensees should do a self-assessment and identify and explain divergence (in actual) in the succeeding ICAAP documents and confirm remedial action.

8.1.9 The ICAAP document should, inter alia, include the capital adequacy assessment and projections of capital requirement for the ensuing year, along with the plans and strategies for meeting the capital requirement. The Licensees should finalise their business policies (also plans, budgets, etc.) to be in place simultaneous with the ICAAP exercise.
8.1.10 An illustrative outline of a format of the ICAAP document is furnished in Attachment 11.3, for guidance of the Licensees, though the ICAAP documents of the Licensees could vary in length and format, in tune with their size, level of complexity, risk profile and scope of operations.

8.1.11 Licensees should focus on effective and efficient capital planning, as well as long-term capital maintenance.

8.1.12 Licensees should assess both the risks to which it is exposed and the risk management processes in place to manage and mitigate those risks; evaluate its capital adequacy relative to its risks; and consider the potential impact on earnings and capital from economic downturns.

8.1.13 A Licensee’s capital planning process should incorporate rigorous, forward-looking stress testing, as discussed later in this document.

8.2 Guidelines for SREP of Central Bank and Licensees’ ICAAP

8.2.1 Four key principles in regard to the Supervisory Review Process (SRP) envisaged under Pillar 2 are as follows:

8.2.2 **Principle 1**: Licensees should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

8.2.3 **Principle 2**: Supervisor should review and evaluate Licensees’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with the regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

8.2.4 **Principle 3**: Supervisor should expect Licensees to operate above the minimum regulatory capital ratios and should have the ability to require Licensees to hold capital in excess of the minimum.

8.2.5 **Principle 4**: Supervisor should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular Licensee and should require rapid remedial action if capital is not maintained or restored.

8.2.6 The Pillar 2 (Supervisory Review Process - SRP) requires Licensees to implement an internal process called ICAAP for assessing their capital adequacy in relation to their risk profiles as well as a strategy for maintaining their capital levels. The Pillar 2 also requires the supervisory authorities to subject all Licensees to an evaluation process, hereafter called Supervisory Review and
Evaluation Process (SREP), and to initiate such supervisory measures on that basis, as might be considered necessary.

8.2.7 The principles stated above, as outlined by Basel Committee and IFSB as regards SREP, have been approved to be implemented by Licensees. An analysis of the principles indicates that the following broad responsibilities have been cast on Licensees and the supervisors:

8.2.8 Licensees’ responsibilities

8.2.8.1 Licensees should have in place a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels (Principle 1).

8.2.8.2 Licensees should operate above the minimum regulatory capital ratios (Principle 3).

8.2.9 Supervisors’ responsibilities

8.2.9.1 Supervisors should review and evaluate a Licensee’s ICAAP (Principle 2).

8.2.9.2 Supervisors should take appropriate action if they are not satisfied with the results of this process (Principle 2).

8.2.9.3 Supervisors should review and evaluate a Licensee’s compliance with the regulatory capital ratios (Principle 2).

8.2.9.4 Supervisors should have the ability to require Licensees to hold capital in excess of the minimum (Principle 3).

8.2.9.5 Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels (Principle 4).

8.2.9.6 Supervisors should require rapid remedial action if capital is not maintained or restored (Principle 4).

8.2.10 ICAAP and SREP are the two important components of Pillar 2 and could be broadly defined as follows:

8.2.11 The ICAAP comprises a Licensee’s procedures and measures designed to ensure the following:

8.2.11.1 An appropriate identification and measurement of risks;

8.2.11.2 An appropriate level of internal capital in relation to the Licensee’s risk profile; and

8.2.11.3 Application and further development of suitable risk management systems in the Licensee.

8.2.12 The SREP consists of a review and evaluation process adopted by the supervisor, which covers all the processes and measures defined in the principles listed above. Essentially, these include the
review and evaluation of the Licensee’s ICAAP, conducting an independent assessment of the Licensee’s risk profile, and if necessary, taking appropriate prudential measures and other supervisory actions.

8.2.13 These guidelines seek to provide broad guidance to Licensees by outlining the manner in which the SREP would be carried out by the Central Bank, the expected scope and design of their ICAAP, and the expectations of the Central Bank from the Licensees in regard to the implementation of the ICAAP.

8.3 Conduct of the SREP by the Central Bank

8.3.1 Regulatory capital ratios permit some comparative analysis of capital adequacy across regulated banking entities because they are based on certain common methodology / assumptions.

8.3.2 The Central Bank expects the Licensees to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, to account for all material risks. Under the SREP, the Central Bank will assess the overall capital adequacy of a Licensee through a comprehensive evaluation that takes into account all relevant available information. In determining the extent to which the Licensees should hold capital in excess of the regulatory minimum, the Central Bank would take into account the combined implications of a Licensee’s compliance with regulatory minimum capital requirements, the quality and results of a Licensee’s ICAAP, and supervisory assessment of the Licensee’s risk management processes, control systems and other relevant information relating to the Licensee’s risk profile and capital position.

8.3.3 The SREP of the Licensees would, thus, be conducted by the Central Bank periodically, generally along with the Central Bank’s on-site examination of the Licensees and in the light of the latest risk profile document prepared on the Licensees based on off-site data and other information, in conjunction with the ICAAP document, which is required to be submitted every year by the Licensees to the Central Bank. Through the SREP, the Central Bank would evaluate the adequacy and efficacy of the ICAAP of the Licensees and the capital requirements derived by them. While in the course of evaluation, there would be no attempt to reconcile the difference between the regulatory minimum CAR and the outcome of the ICAAP of a Licensee (as the risks covered under the two processes are different).

8.3.4 Licensees would be expected to demonstrate to the Central Bank that the ICAAP adopted by them is fully responsive to their size, level of complexity, scope and scale of operations
and the resultant risk profile / exposures, and adequately captures their capital requirements. Such an evaluation of the effectiveness of the ICAAP would help the Central Bank in understanding the capital management processes and strategies adopted by the Licensees. If considered necessary, the SREP could also involve a dialogue between the Licensees’ top management and the Central Bank from time to time.

8.3.5 Under the SREP, the Central Bank would determine a Licensee’s overall capital remains adequate as the underlying conditions change. Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital. Conversely, reductions in overall capital (to a level still above regulatory minimum) may be appropriate if the Central Bank’s supervisory assessment leads it to a conclusion that risk has materially declined or that it has been appropriately mitigated. Based on such an assessment, the Central Bank could consider initiating appropriate supervisory measures to address its supervisory concerns. The measures could include requiring a modification or enhancement of the risk management and internal control processes of a Licensee, a reduction in risk exposures, or any other action as deemed necessary to address the identified supervisory concerns. These measures could also include the stipulation of a bank-specific minimum CRAR that could potentially be even higher, if so warranted by the facts and circumstances, than the regulatory minimum stipulated under the Pillar 1. In cases where the Central Bank decides to stipulate a CRAR at a level higher than the regulatory minimum, it would explain the rationale for doing so to the Licensee concerned.

8.3.6 As and when the advanced approaches envisaged in the Basel II document are permitted to be adopted by the Licensees, the SREP would also assess the ongoing compliance by Licensees with the eligibility criteria for adopting the advanced approaches.

8.4 The Structural Aspects of the ICAAP

8.4.1 Every Licensee shall have an ICAAP reckoning that Capital Adequacy framework is applicable to all Licensees, both at the solo level as well as at the consolidated level (global position). This requirement would also apply to the foreign banks which have a branch presence in the Sultanate should also have their ICAAP covering Oman operations only.

8.5 General Firm-Wide Risk Management Principles

8.5.1 A sound risk management system should have the following key features:

8.5.1.1 Active board and senior management oversight;

8.5.1.2 Appropriate policies, procedures and limits;
8.5.1.3 Comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks, appropriate management information systems (MIS) at the business and firm-wide level; and

8.5.1.4 Comprehensive internal controls, review and revision.

8.6 **Board and Senior Management Oversight**

8.6.1 The ultimate responsibility for designing and implementing the ICAAP lies with the Licensee’s Board of Directors and with the Chief Executive Officer in the case of the foreign banks with branch presence in Oman.

8.6.2 It is the responsibility of the Board of Directors and senior management to define the institution’s risk appetite and to ensure that the Licensee’s risk management framework includes detailed policies that set specific firm-wide prudential limits on the Licensee’s activities which are consistent with its risk taking appetite and capacity (apart from the prudential regulatory requirements). In order to determine the overall risk appetite, the board and senior management must first have an understanding of risk exposures on a firm-wide basis.

8.6.3 Senior management must overcome organisational silos between business lines and share information on market developments, risks and risk mitigation techniques.

8.6.4 Senior management should establish a risk management process that is not limited to credit, market, liquidity and operational risks, but incorporates all material risks. This includes reputational, legal and strategic risks, as well as risks that do not appear to be significant in isolation, but when combined with other risks could lead to material losses. The board of directors and senior management should possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls and risk monitoring systems are effective.

8.6.5 The board and senior management should remain informed on an on-going basis about these risks as financial markets, risk management practices and the Licensee’s activities evolve. In addition, the board and senior management should ensure that accountability and lines of authority are clearly delineated. With respect to new or complex products and activities, senior management should understand the underlying assumptions regarding business models, valuation and risk management practices. In addition, senior management should evaluate the potential risk exposure if those assumptions fail.

8.6.6 Before embarking on new activities or introducing products new to the institution, the board and senior management should identify and review the changes in firm-wide risks
arising from these potential new products or activities and ensure that the infrastructure and internal controls necessary to manage the related risks are in place. In this review, a Licensee should also consider the possible difficulty in valuing the new products and how they might perform in a stressed economic environment.

8.6.7 The Board should ensure that the senior management of the Licensee:

8.6.7.1 establishes a risk framework in order to assess and appropriately manage the various risk exposures of the Licensee;

8.6.7.2 develops a system to monitor the Licensee's risk exposures and to relate them to the Licensee's capital and reserve funds, while taking into account loss recovery and related corrective steps;

8.6.7.3 establishes a method to monitor the Licensee’s compliance with internal policies, particularly in regard to risk management; and

8.6.7.4 effectively communicates all relevant policies and procedures throughout the institution.

8.6.8 A Licensee’s risk function and its Chief Risk Officer (CRO) or equivalent position should be independent of the individual business lines and report directly to the CEO/Managing Director and the institution’s board of directors. However, in case of domestic banks, the CRO should report directly to the board or board risk committee (preferably to an independent director of board risk committee). In addition, the risk function should highlight to senior management and the board risk management concerns, such as risk concentrations and violations of risk appetite limits.

8.7 Policies, Procedures, Limits and Controls

8.7.1 The structure, design and contents of a Licensee's ICAAP should be approved by the board of directors to ensure that the ICAAP forms an integral part of the management process and decision making culture of the Licensee.

8.7.2 Firm-wide risk management programmes should include detailed policies that set specific firm-wide prudential limits on the principal risks relevant to a Licensee’s activities. A Licensee’s policies and procedures should provide specific guidance for the implementation of broad business strategies and should establish, where appropriate, internal limits for the various types of risk to which the Licensee may be exposed (apart from the prudential regulatory requirements). These limits should consider the Licensee’s role in the financial system and be defined in relation to the Licensee’s capital, total assets, earnings or, where
adequate measures exist, its overall risk level.

8.7.3 A Licensee’s policies, procedures and limits should:

8.7.3.1 Provide for adequate and timely identification, measurement, monitoring, control and mitigation of the risks posed by its financing, investing, trading, off-balance sheet and other significant activities at the business line and firm-wide levels;

8.7.3.2 Ensure that the economic substance of a Licensee’s risk exposures, including reputational risk and valuation uncertainty, are fully recognised and incorporated into the Licensee’s risk management processes;

8.7.3.3 Be consistent with the Licensee’s stated goals and objectives, as well as its overall financial strength;

8.7.3.4 Clearly delineate accountability and lines of authority across the Licensee’s various business activities, and ensure there is a clear separation between business lines and the risk function;

8.7.3.5 Escalate and address breaches of internal position limits;

8.7.3.6 Provide for the review of new businesses and products by bringing together all relevant risk management, control and business lines to ensure that the Licensee is able to manage and control the activity prior to it being initiated; and

8.7.3.7 Include a schedule and process for reviewing the policies, procedures and limits and for updating them as appropriate.

8.8 Identifying, Measuring, Monitoring and Reporting of Risk

8.8.1 A Licensee’s MIS should provide the board and senior management in a clear and concise manner with timely and relevant information concerning the institution’s risk profile. This information should include all risk exposures, including those that are off-balance sheet. Management should understand the assumptions behind and limitations inherent in specific risk measures. The key elements necessary for the aggregation of risks are an appropriate infrastructure and MIS that (i) allow for the aggregation of exposures and risk measures across business lines and (ii) support customised identification of concentrations and emerging risks. MIS developed to achieve this objective should support the ability to evaluate the impact of various types of economic and financial shocks that affect the whole of the financial institution.

8.8.2 The Licensee’s systems should be flexible enough to incorporate hedging and other risk
mitigation actions to be carried out on a firm-wide basis while taking into account the various related risks.

8.8.3 To enable proactive management of risk, the board and senior management should ensure that MIS is capable of providing regular, accurate and timely information on the Licensee’s aggregate risk profile, as well as the main assumptions used for risk aggregation. MIS should be adaptable and responsive to changes in the Licensee’s underlying risk assumptions and should incorporate multiple perspectives of risk exposure to account for uncertainties in risk measurement. In addition, it should be sufficiently flexible so that the institution can generate forward-looking bank-wide scenario analyses that capture the management’s interpretation of evolving market conditions and stressed conditions. Third-party inputs or other tools used within MIS (e.g. credit ratings, risk measures, models) should be subject to initial and ongoing validation.

8.8.4 A Licensee’s MIS should be capable of capturing limit breaches and there should be procedures in place to promptly report such breaches to senior management, as well as to ensure that appropriate follow-up actions are taken. For instance, similar exposures should be aggregated across business platforms (including the Islamic Banking and trading books) to determine whether there is a concentration or a breach of an internal position limit.

8.9 **Internal Controls**

8.9.1 Risk management processes should be frequently monitored and tested by independent control and internal, as well as external, auditors.

8.9.2 *The aim of monitoring is to ensure that the information on which decisions are based is accurate so that processes fully reflect management policies and that regular reporting, including the reporting of limit breaches and other exception-based reporting, is undertaken effectively.*

8.9.3 The risk management function of the Licensees must be independent of the business lines in order to ensure an adequate separation of duties and to avoid conflict of interest. Since a sound risk management process provides the basis for ensuring that a Licensee maintains adequate capital, the board of directors of a Licensee shall set the tolerance level for risk.

8.10 **Submission of the ICAAP Outcome to Board and Central Bank**

8.10.1 As the ICAAP is an ongoing process, a written record on the outcome of the ICAAP should to be periodically submitted by the Licensees to their Board of Directors. Such written record of the internal assessment of its capital adequacy should include, *inter alia*, the risks
identified, the manner in which those risks are monitored and managed, the impact of the Licensee’s changing risk profile on the Licensee’s capital position, details of stress tests/scenario analyses conducted and the resultant capital requirements. The reports shall be sufficiently detailed to allow the Board of Directors to evaluate the level and trend of material risk exposures, whether the Licensee maintains adequate capital against the risk exposures and in case of additional capital being needed, the plan for augmenting capital. The Board of Directors would be expected to make timely adjustments to the strategic plan, as necessary.

8.10.2 Review of the ICAAP outcomes

8.10.2.1 The board of directors shall, at least once a year, assess and document whether the processes relating the ICAAP implemented by the Licensee successfully achieve the objectives envisaged by the board.

8.10.2.2 The senior management should also receive and review the reports regularly to evaluate the sensitivity of the key assumptions and to assess the validity of the Licensee’s estimated future capital requirements. In the light of such an assessment, appropriate changes in the ICAAP should be instituted to ensure that the underlying objectives are effectively achieved.

8.10.3 ICAAP to be an Integral part of the management and decision-making culture

8.10.3.1 ICAAP should from an integral part of the management and decision-making culture of a Licensee. This integration could range from using the ICAAP to internally allocate capital to various business units, to having it play a role in the individual credit decision process and pricing of products or more general business decisions such as expansion plans and budgets. The integration would also mean that ICAAP should enable the Licensee management to assess, on an ongoing basis, the risks that are inherent in their activities and material to the institution. Thus there is a need for two-way communications between ICAAP on the one hand and policy, budgeting, performance reviews and revisions on the other.

8.10.4 The principle of proportionality

8.10.4.1 The implementation of ICAAP should be guided by the principle of proportionality. Though Licensees are encouraged to migrate to and adopt progressively sophisticated approaches in designing their ICAAP, the Central Bank would assess during on-site examination the degree of sophistication adopted in the ICAAP in regard to risk measurement and management, to be commensurate with the nature, scope, scale and the
degree of complexity in the Licensee’s business operations. The following paragraphs illustratively enumerate the broad approach which could be considered by Licensees with varying levels of complexity in their operations in formulating their ICAAP.

8.10.4.2 In relation to a Licensee that defines its activities and risk management practices as simple, in carrying out its ICAAP, that Licensee could:

8.10.4.2.1 identify and consider that Licensee’s largest losses over the last 3 to 5 years and whether those losses are likely to recur;

8.10.4.2.2 prepare a short list of the most significant risks to which that Licensee is exposed;

8.10.4.2.3 consider how that Licensee would act, and the amount of capital that would be absorbed in the event that each of the risks identified were to materialise;

8.10.4.2.4 consider how that Licensee’s capital requirement might alter under the scenarios in Article 8.10.4.2.3) and how its capital requirement might alter in line with its business plans for the next 3 to 5 years; and

8.10.4.2.5 document the ranges of capital required in the scenarios identified above and form an overall view on the amount and quality of capital which that Licensee should hold, ensuring that its senior management is involved in arriving at that view.

8.10.4.3 In relation to a Licensee that defines its activities and risk management practices as moderately complex, in carrying out its ICAAP, that Licensee could:

8.10.4.3.1 having consulted the operational management in each major business line and prepare a comprehensive list of the major risks to which the business is exposed;

8.10.4.3.2 estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using shock stress tests to provide risk estimates;

8.10.4.3.3 consider the extent to which that Licensee’s capital requirement adequately captures the risks identified in Article 8.10.4.3.1 and Article 8.10.4.3.2 above;

8.10.4.3.4 for areas in which the capital requirement is either inadequate or does not address a risk, estimate the additional capital needed to protect that Licensee and its customers, in addition to any other risk mitigation action that the Licensee plans to take;

8.10.4.3.5 consider the risk that the Licensee’s own analyses of capital adequacy may be inaccurate and that it may suffer from management weaknesses which affect the effectiveness of its risk management and mitigation;
8.10.4.3.6 project that Licensee’s business activities forward in detail for one year and in less detail for the next 3 to 5 years, and estimate how that Licensee’s capital and capital requirement would alter, assuming that business develops as expected;

8.10.4.3.7 assume that business does not develop as expected and consider how that Licensee’s capital and capital requirement would alter and what that Licensee’s reaction to a range of adverse economic scenarios might be;

8.10.4.3.8 document the results obtained from the analyses in 8.10.4.3.2, 8.10.4.3.4, 8.10.4.3.6, 8.10.4.3.7 above in a detailed report for that Licensee’s top management / board of directors; and

8.10.4.3.9 Ensure that systems and processes are in place to review the accuracy of the estimates made in 8.10.4.3.2, 8.10.4.3.4, 8.10.4.3.6, 8.10.4.3.7, (i.e., systems for back testing) vis-à-vis the performance / actual.

8.10.5 In relation to a Licensee that defines its activities and risk management practices as complex, in carrying out its ICAAP, it could follow a proportional approach to that Licensee’s ICAAP which should cover the issues identified in Article 8.10.4.3.1, 8.10.4.3.2, 8.10.4.3.3, 8.10.4.3.4 above, but is likely also to involve the use of models, most of which will be integrated into its day-to-day management and operations. Models of the kind referred to above may be linked so as to generate an overall estimate of the amount of capital that a Licensee considers appropriate to hold for its business needs. A Licensee may also link such models to generate information on the economic capital considered desirable for that Licensee.

8.10.6 Economic capital is the target amount of capital which optimises the return for a Licensee’s stakeholders for a desired level of risk. For example, a Licensee is likely to use value-at-risk (VaR) models for market risk, advanced modelling approaches for credit risk and, possibly, advanced measurement approaches for operational risk, as and when permitted by the Central Bank.

8.11 Regular Independent Review and Validation

8.11.1 The ICAAP should be subject to regular and independent review through an internal or external audit process, separately from the SREP conducted by the Central Bank, to ensure that the ICAAP is comprehensive and proportionate to the nature, scope, scale and level of complexity of the Licensee’s activities so that it accurately reflects the major sources of risk that the Licensee is exposed to. A Licensee shall ensure appropriate and effective internal control structures, particularly in regard to the risk management processes, in order to
monitor the Licensee’s continued compliance with internal policies and procedures. As a minimum, a Licensee shall conduct periodic reviews of its risk management processes, which should ensure:

8.11.1 The integrity, accuracy, and reasonableness of the processes;

8.11.2 The appropriateness of the Licensee’s capital assessment process based on the nature, scope, scale and complexity of the Licensee’s activities;

8.11.3 The timely identification of any concentration risk;

8.11.4 The accuracy and completeness of any data inputs into the Licensee’s capital assessment process;

8.11.5 The reasonableness and validity of any assumptions and scenarios used in the capital assessment process;

8.11.6 That the Licensee conducts appropriate stress testing.

8.12 ICAAP to be a Forward-Looking Process

8.12.1 The ICAAP should be forward looking in nature, and thus, should take into account the expected / estimated future developments such as strategic plans, macro economic factors, etc., including the likely future constraints in the availability and use of capital.

8.12.2 As a minimum, the management of a Licensee shall develop and maintain an appropriate strategy that would ensure that the Licensee maintains adequate capital commensurate with the nature, scope, scale, complexity and risks inherent in the Licensee’s on-balance-sheet and off-balance-sheet activities, and should demonstrate as to how the strategy dovetails with the macro-economic factors. Thus, Licensees shall have an explicit, board-approved capital plan which should spell out the institution's objectives in regard to level of capital, the time horizon for achieving those objectives, and in broad terms, the capital planning process and the allocate responsibilities for that process. As already stated, the Licensees can also attempt a medium term (say 3-5 years) ICAAP exercise, along with medium term business plans, keeping in view the need for having longer term perspectives. The plan shall outline:

8.12.2.1 The Licensee’s capital needs;

8.12.2.2 The Licensee’s anticipated capital utilisation;

8.12.2.3 The Licensee’s desired level of capital;
8.12.2.4 Limits related to capital;

8.12.2.5 A general contingency plan for dealing with divergences and unexpected events.

8.13 **ICAAP to be a Risk-Based Process**

8.13.1 The adequacy of a Licensee’s capital is a function of its risk profile. Licensees shall, therefore, set their capital targets which are consistent with their risk profile and operating environment. As a minimum, a Licensee shall have in place a sound ICAAP, which shall include all material risk exposures incurred by the Licensee. There are some types of risks (such as reputation risk and strategic risk) which are less readily quantifiable; for such risks, the focus of the ICAAP should be more on qualitative assessment, risk management and mitigation than on quantification of such risks. Licensees’ ICAAP document shall clearly indicate for which risks a quantitative measure is considered warranted, and for which risks a qualitative measure is considered to be the correct approach. Domestic banks may try to assess the past impact of ‘non quantifiable’ material risks and try to provide for a quantified cushion.

8.14 **ICAAP to Include Stress Tests and Scenario Analyses**

8.14.1 As part of the ICAAP, the management of a Licensee shall, as a minimum, conduct relevant stress tests periodically, particularly in respect of the Licensee’s material risk exposures, in order to evaluate the potential vulnerability of the Licensee to some unlikely but plausible events or movements in the market conditions that could have an adverse impact on the Licensee. The use of stress testing framework can provide a Licensee’s management a better understanding of the Licensee’s likely exposure in extreme circumstances. In this context, attention is also invited to the Central Bank letter BSD/2005/BKUP/banks/01 dated January 4, 2005 on stress testing wherein the Licensees were advised to carry out stress tests on a regular basis for the information of their top management, so as to gauge their resilience to possible stress scenarios. The Licensees are urged to take necessary measures for implementing an appropriate formal stress testing framework which would also meet the stress testing requirements under the ICAAP of the Licensees.

8.15 **Use of Capital Models for ICAAP**

8.15.1 While the Central Bank does not expect the Licensees to use complex and sophisticated econometric models for internal assessment of their capital requirements, the Licensees
operating in international markets, if required, may develop suitable methodologies for estimating economic capital. Licensees who have relatively complex operations and are adequately equipped in this regard may like to place reliance on such models as part of their ICAAP. While there is no single prescribed approach as to how a Licensee should develop its capital model, a Licensee adopting a model-based approach to its ICAAP shall be able to, \textit{inter alia}, demonstrate:

8.15.2 Well documented model specifications, including the methodology / mechanics and the assumptions underpinning the working of the model;

8.15.3 The extent of reliance on the historical data in the model and the system of back testing to be carried out to assess the validity of the outputs of the model vis-à-vis the actual outcomes;

8.15.4 A robust system for independent validation of the model inputs and outputs;

8.15.5 A system of stress testing the model to establish that the model remains valid even under extreme conditions / assumptions;

8.15.6 The level of confidence assigned to the model outputs and its linkage to the Licensee’s business strategy;

8.15.7 The adequacy of the requisite skills and resources within the Licensees to operate, maintain and develop the model.

8.16 \textbf{Select Operational Aspects of the ICAAP}

8.16.1 \textit{This Article outlines in somewhat greater detail the scope of the risk universe expected to be normally captured by the Licensees in their ICAAP.}

8.16.2 \textit{Identifying and measuring material risks in ICAAP}

8.16.3 \textit{The first objective of an ICAAP is to identify all material risks. Risks that can be reliably measured and quantified should be treated as rigorously as data and methods allow. The appropriate means and methods to measure and quantify those material risks are likely to vary across banks. Some of the risks to which banks are exposed include credit risk, market risk, operational risk, credit concentration risk and liquidity risk (as briefly outlined below). Central Bank of Oman has issued guidelines to the Licensees on risk management and management of country and transfer risk apart from elaborate guidelines on Basel II. A Licensee’s risk management processes, including its ICAAP, should therefore be consistent with this existing body of guidance. However, certain other risks, such as reputational risk and business or strategic risk, may be equally important for a
Licensee and, in such cases, should be given same consideration as the more formally defined risk types. Additionally, if Licensees employ risk mitigation techniques, they should understand the risk to be mitigated and the potential effects of that mitigation, reckoning its enforceability and effectiveness on the risk profile of the Licensee.

8.16.4 **Credit risk**: A Licensee should have the ability to assess credit risk at the portfolio level as well as at the exposure or counterparty level. Licensees should be particularly attentive to identifying credit risk concentrations and ensuring that their effects are adequately assessed. This should include consideration of various types of dependence among exposures, incorporating the credit risk effects of extreme outcomes, stress events, and shocks to the assumptions made about the portfolio and exposure behaviour. Licensees should also carefully assess concentrations in counterparty credit exposures and determine the effect that these might have on the Licensee’s capital adequacy.

8.16.5 **Market risk**: A Licensee should be able to identify risks in trading activities resulting from a movement in market prices. This determination should consider factors such as illiquidity of instruments, concentrated positions, one-way markets, defeasance period and the potential for significant shifts in correlations. Also, in the absence of market price of various financial assets, method suggested under applicable accounting standard may be adopted to arrive at the price. Exercises that incorporate extreme events and shocks should also be tailored to capture key portfolio vulnerabilities to the relevant market developments.

8.16.6 **Operational risk**: A Licensee should be able to assess the potential risks resulting from inadequate or failed internal processes, people, and systems, as well as from events external to the Licensee. This assessment should include the effects of extreme events and shocks relating to operational risk. Events could include a sudden increase in failed processes across business units or a significant incidence of failed internal controls.

8.16.7 Further, the performance of specialised portfolios may, in some instances, also depend on key individuals / employees of the Licensee. The impact of such key employees / individuals is likely to be correspondingly greater in smaller banks. In developing its stress tests and scenario analyses, a Licensee should, therefore, also consider the impact of losing key personnel on its ability to operate normally, as well as the direct impact on its revenues.

8.16.8 **Rate of return risk in the Islamic Banking book**: A Licensee should identify the risks associated with the changing benchmark rates on its on-balance sheet and off-balance sheet exposures in the Islamic Banking book from both short-term and long-term perspectives. This might include the impact of changes due to parallel shocks, yield curve twists, yield curve inversions, changes in the relationships of rates (basis risk), and other relevant
scenarios. The Licensee should be able to support its assumptions about the behavioural characteristics of its non-maturity deposits/investment accounts and other assets and liabilities, especially those exposures characterised by embedded optionality. Given the uncertainty in such assumptions, stress testing and scenario analysis should be used in the analysis of rate of return risks. The Licensees should adopt any approach for computing / quantifying this risk based on objective, verifiable and transparent methodology and criteria.

8.16.9 **Credit concentration risk:** A risk concentration is any single exposure or a group of exposures with the potential to produce losses large enough (relative to a Licensee’s capital, total assets, or overall risk level) to threaten a Licensee’s health or ability to maintain its core operations. Risk concentrations have arguably been the single most important cause of major problems in banks. The following qualitative criteria could be adopted by the Licensees to demonstrate that the credit concentration risk is being adequately addressed:

8.16.10 While assessing the exposure to concentration risk, a Licensee should keep in view that the calculations of Basel II framework are based on the assumption that a Licensee is well diversified.

8.16.11 While the Licensees’ single customer exposures, the group customer exposures and capital market exposures are regulated by the exposure norms prescribed by the Central Bank and the Banking Law, there could be concentrations in these portfolios as well. In assessing the degree of credit concentration, therefore, a Licensee should consider not only the foregoing exposures but also the degree of credit concentration in a particular economic sector or geographical area. Licensees with operational concentration in a few geographical regions, by virtue of the pattern of their branch network, should also consider the impact of adverse economic developments in that region, and their impact on the asset quality.

8.16.12 As regards the quantitative criteria to be used to ensure that credit concentration risk is being adequately addressed, the credit concentration risk calculations shall be performed at the counterparty level (i.e. large exposures), at the portfolio level (i.e. sectoral and geographical concentrations) and at the asset class level (i.e. liability and asset concentrations). In this regard, a reference is invited to Article 4 in Credit Risk Title. The Licensees would also be well advised to pay special attention to their industry-wise exposures.

8.16.13 *There could be several approaches to the measurement of credit concentration in the Licensees’ portfolio. One of the approaches commonly used for the purpose involves computation of Herfindahl-Hirshman Index (HHI). It may be noted that the HHI as a measure of concentration risk is only one of the possible methods and the Licensees would be free to adopt any other appropriate*
method for the purpose which has objective and transparent criteria for such measurement. Risk concentrations should be analysed on both solo and consolidated bases. Risk concentrations should be viewed in the context of a single risk-driver or a set of closely related risk-drivers that may have different impacts on a Licensee. These concentrations should be integrated when assessing a Licensee’s overall risk exposure.

8.16.14 A Licensee should consider concentrations that are based on common or correlated risk factors that reflect more subtle or more situation-specific factors than traditional concentrations, such as correlations between market, credit and liquidity risks. This has created new challenges for risk aggregation and concentration management. The Central Bank will assess during on-site examination that through its risk management processes and MIS the Licensee is able to identify and aggregate similar risk exposures across the firm, including across legal entities, asset types (e.g. financing and structured products), risk areas (e.g. the trading book) and geographic regions.

8.16.15 In addition to the above, risk concentrations can arise due to:

8.16.15.1 exposures to a single counterparty, or group of connected counterparties;
8.16.15.2 exposures to both regulated and non-regulated financial institutions
8.16.15.3 Trading exposures / market risk.

8.16.16 Risk concentrations can also arise through a combination of exposures across these broad categories. A Licensee should have an understanding of its firm-wide risk concentrations resulting from similar exposures across its different business lines. Examples of such business lines include subprime exposure in financing books; counterparty exposures; contractual and non-contractual exposures; trading activities and underwriting pipelines. While risk concentrations often arise due to direct exposures to borrowers and obligors, a Licensee may also incur a concentration to a particular asset type indirectly through investments backed by such assets, as well as exposure to protection providers guaranteeing the performance of the specific asset type. In this context, it may be noted that while banks in the Sultanate are presently not allowed to pursue most of such business lines or assume most of such exposures without Central Bank’s permission, their foreign branches may have such exposures. A Licensee should have in place adequate, systematic procedures for identifying high correlation between the creditworthiness of a protection provider and the obligors of the underlying exposures due to their performance being dependent on common factors beyond systematic risk. Procedures should be in place to communicate risk concentrations to the board of directors and senior management in a manner that clearly indicates where in the organisation each segment of a risk concentration resides.
8.16.17 A Licensee should have credible risk mitigation strategies in place that have senior management approval with the guidance provided by the board of directors. This may include altering business strategies, reducing limits or increasing capital buffers in line with the desired risk profile. Licensees should employ a number of techniques, as appropriate, to measure risk concentrations. These techniques include shocks to various risk factors; use of business level and firm-wide scenarios and the use of integrated stress testing and economic capital models. Identified concentrations should be measured in a number of ways, including, for example, consideration of gross versus net exposures, use of notional amounts and analysis of exposures with and without counterparty hedges. A Licensee should establish internal position limits for concentrations to which it may be exposed. When conducting periodic stress tests a Licensee should incorporate all major risk concentrations and identify and respond to potential changes in market conditions that could adversely impact its performance and capital adequacy.

8.16.18 The assessment of such risks under a Licensee’s ICAAP and the supervisory review process should not be a mechanical process, but one in which each institution determines, depending on its business model, its own specific vulnerabilities. An appropriate level of capital for risk concentrations should be incorporated in a Licensee’s ICAAP, as well as in Pillar 2 assessments. A Licensee should have in place effective internal policies, systems and controls to identify, measure, monitor, manage, control and mitigate its risk concentrations in a timely manner. Not only should normal market conditions be considered, but also the potential build-up of concentrations under stressed market conditions, economic downturns and periods of general market illiquidity. In addition, the Licensee should assess scenarios that consider possible concentrations arising from contractual and non-contractual contingent claims. The scenarios should also combine the potential build-up of pipeline exposures together with the loss of market liquidity and a significant decline in asset values.

8.16.19 **Liquidity risk:** A Licensee should understand the risks resulting from its inability to meet its obligations as they come due, because of the difficulty in liquidating assets (market liquidity risk) or in obtaining adequate funding (funding liquidity risk). This assessment should include analysis of sources and uses of funds, an understanding of the funding markets in which the Licensee operates, and an assessment of the efficacy of a contingency funding plan for events that could arise.

8.16.20 *Liquidity Risk Title prescribes detailed guidelines on maturities and sensitivities aspects of liquidity management by the Licensees. Further, in September 2008, the Basel Committee on Banking*
Supervision published Principles for Sound Liquidity Risk Management and Supervision, which stresses that financial institutions need to have strong liquidity cushions in order to weather prolonged periods of financial market stress and illiquidity. The standards address many of the shortcomings experienced by the Islamic Banking sector during the market turmoil that began in mid-2007, including those related to stress testing practices, contingency funding plans, management of on- and off-balance sheet activity and contingent commitments. This liquidity guidance outlines requirements for sound practices for the liquidity risk management of banks. The fundamental principle is that a bank should both assiduously manage its liquidity risk and also maintain sufficient liquidity to withstand a range of stress events. Liquidity is a critical element of a bank’s resilience to stress, and as such, a Licensee should maintain a liquidity cushion, made up of unencumbered, high quality liquid assets, to protect against liquidity stress events, including potential losses of unsecured and typically available secured funding sources.

8.16.21 A key element in the management of liquidity risk is the need for strong governance of liquidity risk, including the setting of a liquidity risk tolerance by the board. The risk tolerance should be communicated throughout the institution and reflected in the strategy and policies that senior management set to manage liquidity risk. Another facet of liquidity risk management is that a Licensee should appropriately price the costs, benefits and risks of liquidity into the internal pricing, performance measurement and new product approval process of all significant business activities. A Licensee is expected to be able to thoroughly identify, measure and control liquidity risks, especially with regards to complex products and contingent commitments (both contractual and non-contractual). This process should involve the ability to project cash flows arising from assets, liabilities and off-balance sheet items over various time horizons, and should ensure diversification in both the tenor and source of funding.

8.16.22 A Licensee should utilise early warning indicators to identify the emergence of increased risk or vulnerabilities in its liquidity position or funding needs. It should have the ability to control liquidity risk exposure and funding needs, regardless of its organisation structure, within and across legal entities, business lines, and currencies, taking into account any legal, regulatory and operational limitations to the transferability of liquidity. A Licensee’s failure to effectively manage intra-day liquidity could leave it unable to meet its payment obligations at the time expected, which could lead to liquidity dislocations that cascade quickly across many systems and institutions.

8.16.23 As such, the Licensee’s management of intra-day liquidity risks should be considered as a crucial part of liquidity risk management. It should also actively manage its collateral positions and have the ability to calculate all of its collateral positions. While banks
typically manage liquidity under “normal” circumstances, they should also be prepared to
manage liquidity under “stressed” conditions. A Licensee should perform stress tests or
scenario analyses on a regular basis in order to identify and quantify its exposures to
possible future liquidity stresses, analysing possible impacts on its cash flows, liquidity
positions, profitability and solvency. The results of these stress tests should be discussed
thoroughly by the management, and based on this discussion, should form the basis for
taking remedial or mitigating actions to limit the Licensee’s exposures, build up a liquidity
cushion, and adjust its liquidity profile to fit its risk tolerance.

8.16.24 The results of stress tests should also play a key role in shaping the Licensee’s contingency
funding planning, which should outline policies for managing a range of stress events and
clearly set out strategies for addressing liquidity shortfalls in emergency situations. As
public disclosure increases certainty in the market, improves transparency, facilitates
valuation, and strengthens market discipline, it is important that Licensees publicly disclose
information on a regular basis that enables market participants to make informed decisions
about the soundness of their liquidity risk management framework and liquidity position.

8.17 Off-Balance Sheet Exposures

8.17.1 Very often these expose the Licensees to additional and unexpected credit, market and
liquidity risk, which put significant pressure on their financial profile and capital ratios. To
help mitigate these risks, a Licensee’s on and off-balance sheet activities should be
included in its risk management disciplines, such as product approval, risk concentration
limits, and estimates of market, credit and operational risk. In light of the wide range of
risks arising from off-balance sheet activities, which can be compounded by rapid
innovation in techniques and instruments, minimum capital requirements calculated under
Pillar 1 are often insufficient. All risks arising from them, particularly those that are not
fully captured under Pillar 1, should be addressed in a Licensee’s ICAAP.

8.17.2 These risks include:

8.17.2.1 Credit and market risk of each exposure;
8.17.2.2 Liquidity and reputational risk of each exposure;
8.17.2.3 Potential delinquencies and losses on the underlying exposures;
8.17.2.4 Exposures from credit lines or liquidity facilities to special purpose entities;
8.17.2.5 Exposures from guarantees provided by third parties.
8.17.2.6 These exposures should also be included in the Licensee’s MIS to help ensure that senior management understands the implications of such exposures for liquidity, earnings, risk concentration and capital. More specifically, a Licensee should have the necessary processes in place to capture in a timely manner updated information on off-balance sheet transactions including market data, if available.

8.18 Reputational Risk and Implicit Support

8.18.1 Reputational risk can be defined as the risk arising from negative perception on the part of customers, counterparties, shareholders, investors, Sukuk-holders, market analysts, general public, other relevant parties or regulators that can adversely affect a Licensee’s ability to maintain existing, or establish new, business relationships and continued access to sources of funding. Reputational risk is multidimensional and reflects the perception of other market participants. Furthermore, it exists throughout the organisation and exposure to reputational risk is essentially a function of the adequacy of the Licensee’s internal risk management processes, as well as the manner and efficiency with which the management responds to external influences on bank-related transactions. Thus it calls for due diligence on the part of all concerned on an enterprise-wide basis.

8.18.2 Reputational risk can lead to credit, liquidity, market and legal risk – all of which can have a negative impact on a Licensee’s earnings, liquidity and capital position. A Licensee should identify potential sources of reputational risk to which it is exposed. These include the Licensee’s business lines, liabilities, affiliated operations, off-balance sheet vehicles and the markets in which it operates. The risks that arise should be incorporated into the Licensee’s risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans.

8.18.3 Reputational risk may also affect a Licensee’s liabilities, since market confidence and an institution’s ability to fund its business are closely related to its reputation. For instance, to avoid damaging its reputation, a Licensee may call its liabilities even though this might negatively affect its liquidity profile. This is particularly true for liabilities that are components of regulatory capital. In such cases, a Licensee’s capital position is likely to suffer.

8.18.4 A Licensee’s stress testing procedures should take account of reputational risk so that the management has a firm understanding of the consequences and second round effects of reputational risk.

8.18.5 Valuation Practices

8.18.6 The characteristics of complex structured products make their valuation inherently difficult
due, in part, to the absence of active and liquid markets, the complexity and uniqueness of the cash waterfalls, and the links between valuations and underlying risk factors. As mentioned earlier, banks in Oman are presently not allowed to assume such exposures. However, their foreign branches may have such exposures. The absence of a transparent price from a liquid market means that the valuation must rely on models or proxy-pricing methodologies, as well as on expert judgment. The outputs of such models and processes are highly sensitive to the inputs and parameter assumptions adopted, which may themselves be subject to estimation error and uncertainty.

8.18.7  
A Licensee is expected to have adequate governance structures and control processes for fair valuing exposures for risk management and financial reporting purposes. The valuation governance structures and related processes should be embedded in the overall governance structure of the Licensee, and consistent for both risk management and reporting purposes.

8.18.8  
The governance structures and processes are expected to explicitly cover the role of the board and senior management. In addition, the board should receive reports from senior management on the valuation oversight and valuation model performance issues that are brought to senior management for resolution, as well as all significant changes to valuation policies.

8.18.9  
A Licensee should also have clear and robust governance structures for the production, assignment and verification of financial instrument valuations. Policies should ensure that the approvals of all valuation methodologies are well documented. In addition, policies and procedures should set forth the range of acceptable practices for the initial pricing, marking-to-market model, valuation adjustments and periodic independent revaluation. New product approval processes should include all internal stakeholders relevant to risk measurement, risk control and the assignment and verification of valuations of financial instruments.

8.18.10  
A Licensee’s control processes for measuring and reporting valuations should be consistently applied across the firm and integrated with risk measurement and management processes. In particular, valuation controls should be applied consistently across similar instruments (risks) and consistent across business lines (books). These controls should be subject to internal audit. Regardless of the booking location of a new product, reviews and approval of valuation methodologies must be guided by a minimum set of considerations. Furthermore, the valuation/new product approval process should be supported by a transparent, well-documented inventory of acceptable valuation methodologies that are specific to products and businesses.

8.18.11  
In order to establish and verify valuations for instruments and transactions in which it engages, a
Licensee must have adequate capacity, including during periods of stress. This capacity should be commensurate with the importance, riskiness and size of these exposures in the context of the business profile of the institution. In addition, for those exposures that represent material risk, a Licensee is expected to have the capacity to produce valuations using alternative methods in the event that primary inputs and approaches become unreliable, unavailable or not relevant due to market discontinuities or illiquidity. A Licensee must test and review the performance of its models under stress conditions so that it understands the limitations of the models under those conditions.

8.18.12 The relevance and reliability of valuations is directly related to the quality and reliability of the inputs. A Licensee is expected to apply the accounting guidance provided to determine the relevant market information and other factors likely to have a material effect on an instrument's fair value when selecting the appropriate inputs to use in the valuation process. Where values are determined to be in an active market, a Licensee should maximise the use of relevant observable inputs and minimise the use of unobservable inputs when estimating fair value using a valuation technique. However, where a market is deemed inactive, observable inputs or transactions may not be relevant, such as in a forced liquidation or distress sale, or transactions may not be observable, such as when markets are inactive. In assessing whether a source is reliable and relevant, a Licensee should consider, among other things:

8.18.12.1 the frequency and availability of the prices/quotes;
8.18.12.2 whether those prices represent actual regularly occurring transactions on an arm's length basis;
8.18.12.3 the breadth of the distribution of the data and whether it is generally available to the relevant participants in the market;
8.18.12.4 the timeliness of the information relative to the frequency of valuations;
8.18.12.5 the number of independent sources that produce the quotes/prices;
8.18.12.6 whether the quotes/prices are supported by actual transactions;
8.18.12.7 the maturity of the market; and
8.18.12.8 the similarity between the financial instrument sold in a transaction and the instrument held by the institution.

8.18.13 A Licensee’s external reporting should provide timely, relevant, reliable and decision useful information that promotes transparency. Senior management should consider whether disclosures around valuation uncertainty can be made more meaningful. For instance, the Licensee may describe the modelling techniques and the instruments to which they are applied; the sensitivity of fair values to modelling inputs and assumptions; and the
impact of stress scenarios on valuations. A Licensee should regularly review its disclosure policies to ensure that the information disclosed continues to be relevant to its business model and products and to current market conditions.

8.18.14 Sound Stress Testing Practices

8.18.15 Stress testing is an important tool that is used by Licensees as part of their internal risk management that alerts their management to adverse unexpected outcomes related to a broad variety of risks, and provides an indication of how much capital might be needed to absorb losses should large shocks occur. Moreover, stress testing supplements other risk management approaches and measures. It plays a particularly important role in:

8.18.15.1 providing forward looking assessments of risk,
8.18.15.2 overcoming limitations of models and historical data,
8.18.15.3 supporting internal and external communication,
8.18.15.4 feeding into capital and liquidity planning procedures,
8.18.15.5 informing the setting of Licensees’ risk tolerance,
8.18.15.6 addressing existing or potential, firm-wide risk concentrations, and
8.18.15.7 facilitating the development of risk mitigation or contingency plans across a range of stressed conditions.

8.18.16 Stress testing is especially important after long periods of benign risk, when the fading memory of negative economic conditions can lead to complacency and the under-pricing of risk, and when innovation leads to the rapid growth of new products for which there is limited or no loss data. It should be recognised that improvements in stress testing alone cannot address all risk management weaknesses, but as part of a comprehensive approach, stress testing has a leading role to play in strengthening Licensees’ corporate governance and the resilience of individual banks and the financial system.

8.18.17 Stress testing should form an integral part of the overall governance and risk management culture of the Licensee. Board and senior management involvement in setting stress testing objectives, defining scenarios, discussing the results of stress tests, assessing potential actions and decision making is critical in ensuring the appropriate use of stress testing in Licensees’ risk governance and capital planning. Senior management should take an active interest in the development in, and operation of, stress testing. The results of stress tests should contribute to strategic decision making and foster internal debate regarding assumptions, such as the cost, risk and speed with which new capital could be raised or that
positions could be hedged or sold.

8.18.18 Board and senior management involvement in the stress testing program is essential for its effective operation. A Licensee’s capital planning process should incorporate rigorous and forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the Licensee. Banks, under their ICAAPs should examine future capital resources and capital requirements under adverse scenarios. In particular, the results of forward-looking stress testing should be considered when evaluating the adequacy of a Licensee’s capital buffer. Capital adequacy should be assessed under stressed conditions against a variety of capital ratios, including regulatory ratios, as well as ratios based on the Licensee’s internal definition of capital resources. In addition, the possibility that a crisis impairs the ability of even very healthy Licensees to raise funds at reasonable cost should be considered.

8.18.19 Sound Compensation Practices

8.18.20 Risk management must be embedded in the culture of a Licensee. It should be a critical focus of the CEO/Managing Director, Chief Risk Officer (CRO), senior management, trading desk and other business line heads and employees in making strategic and day-to-day decisions. For a broad and deep risk management culture to develop and be maintained over time, compensation policies must not be unduly linked to short-term accounting profit generation. Compensation policies should be linked to longer-term capital preservation and the financial strength of the Licensee, and should consider risk-adjusted performance measures. In addition, a Licensee should provide adequate disclosure regarding its compensation policies to stakeholders.

8.18.21 The Licensees should disclose their compensation policies as part of the Pillar 3 disclosure submitted with the annual draft audited financials. Each Licensee’s board of directors and senior management have the responsibility to mitigate the risks arising from remuneration policies in order to ensure effective firm-wide risk management.

8.18.22 To improve compensation practices and strengthen supervision in this area, particularly for systemically important firms, the Financial Stability Board (formerly the Financial Stability Forum) published its Principles for Sound Compensation Practices in April 2009. Central Bank has issued these documents to domestic banks in March, 2010 with an advice to consider the need for any appropriate revision in the compensation framework of banks in the light of the guidance.

8.19 Quantitative and Qualitative Approaches in ICAAP

8.19.1 All measurements of risk incorporate both quantitative and qualitative elements, but to the
extent possible, a quantitative approach should form the foundation of a Licensee’s measurement framework. In some cases, quantitative tools can include the use of large historical databases; when data are more scarce, a Licensee may choose to rely more heavily on the use of stress testing and scenario analyses. Licensees should understand when measuring risks that measurement error always exists, and in many cases the error is itself difficult to quantify. In general, an increase in uncertainty related to modelling and business complexity should result in a larger capital cushion.

8.19.2 Quantitative approaches that focus on most likely outcomes for budgeting, forecasting or performance measurement purposes may not be fully applicable for capital adequacy because the ICAAP should also take less likely events into account. Stress testing and scenario analysis can be effective in gauging the consequences of outcomes that are unlikely but would have a considerable impact on safety and soundness.

8.19.3 To the extent that risks cannot be reliably measured with quantitative tools – for example, where measurements of risk are based on scarce data or unproven quantitative methods – qualitative tools, including experience and judgment, may be more heavily utilised. Licensees should be cognizant that qualitative approaches have their own inherent biases and assumptions that affect risk assessment; accordingly, Licensees should recognise the biases and assumptions embedded in, and the limitations of, the qualitative approaches used.

8.20 Risk Aggregation and Diversification Effects

8.20.1 An effective ICAAP should assess the risks across the entire institution. A Licensee choosing to conduct risk aggregation among various risk types or business lines should understand the challenges in such aggregation. In addition, when aggregating risks, Licensees should ensure that any potential concentrations across more than one risk dimension are addressed, recognising that losses could arise in several risk dimensions at the same time, stemming from the same event or a common set of factors. For example, a localised natural disaster could generate losses from credit, market and operational risks at the same time.

8.20.2 In considering the possible effects of diversification, the management should be systematic and rigorous in documenting decisions, and in identifying assumptions used in each level of risk aggregation. Assumptions about diversification should be supported by analysis and evidence. The Licensee should have systems capable of aggregating risks based on the Licensee’s selected framework. For example, a Licensee calculating correlations within or
among risk types should consider data quality and consistency, and the volatility of correlations over time and under stressed market conditions.
9. **Pillar 3 - Market Discipline**

9.1 **Purpose and Objectives**

9.1.1 The purpose of this Standard is to specify a set of key principles and practices to be followed by the Licensees in making disclosures, with a view to achieving transparency and promoting market discipline in regard to these institutions. The standards (also called Pillar 3) complement the minimum capital requirements (detailed under Pillar 1) and the supervisory review process (detailed under Pillar 2).

9.1.2 For the disclosures to be effective in promoting market discipline, they would need to be complemented by the observance of international standards for good corporate governance of Licensees, and by the availability of a set of other infrastructure components for well-functioning financial markets that serve as the necessary conditions for an effective disclosure regime.

9.1.3 The need for transparency is, above all, an important Shari’a consideration. Any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in Shari’a as mentioned in the Quran and Sunnah.

9.1.4 The objectives of this Standard are: (a) to enable market participants to complement and support, through their actions in the market, the implementation of the capital adequacy requirements as set by the Central Bank, risk management, supervisory review and corporate governance standards; and (b) to facilitate access to relevant, reliable and timely information by market participants generally, and by investment account holders in particular, thereby enhancing their monitoring capacity.

9.1.5 These disclosure principles and practices are designed to enable market participants generally, and IAH in particular, to assess key information on: 1) the type of Licensee and, where applicable, the scope of the consolidation method used by members of an Islamic financial group; 2) capital structure and overview of capital adequacy; 3) the treatment of investment accounts, including their risks and returns; 4) the risk management process; 5) risk exposures by types of risk, and indicators of risk-sharing with IAH; 6) key aspects of general governance and Shari’a governance; 7) the scope of consumer-friendly disclosures concerning such risks and returns, Shari’a compliance and investment account products; and 8) the role of Islamic Windows.

9.1.6 Such disclosures, when combined with adequate market and legal infrastructures, can enable market forces to enhance the stability and soundness of the Islamic banking industry.
in Oman and reinforce other standards set by the Central Bank.

**9.2 Achieving Appropriate Disclosure**

9.2.1 Specific disclosures with regard to the treatment of the risk-weighted assets attributable to the IAH in computing the Licensee’s capital requirements and the related disclosures on displaced commercial risk shall be made the qualifying criteria for the exercise of supervisory discretion in the treatment of these assets in the capital adequacy calculation.

9.2.2 *Market discipline can contribute to a safe and sound banking environment. Hence the Central Bank intends that the Licensees enhance their current degree of disclosures and non-compliance with the requirements would entail supervisory action. However, it is not intended that direct additional capital requirements would be a response to non-disclosure, except as indicated below.*

9.2.3 *In addition to the general intervention measures, the Framework also anticipates a role for specific measures. Where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower risk weighting or the specific methodology).*

**9.3 Interaction with Accounting Disclosures**

9.3.1 Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The Central Bank will consider future modifications to the Market Discipline disclosures as necessary in light of its ongoing monitoring of this area and industry developments. Licensees could leverage the disclosures made under accounting or listing requirements for meeting Pillar 3 expectations. Licensees should explain the material differences between the accounting or other disclosures and supervisory basis of disclosure. Such explanation need not take the form of a line-by-line reconciliation.

9.3.2 *This shall complement the requirements of relevant international accounting standards as well as the Pillar 3 disclosure framework. It reflects the specific information needs of IAH and shareholders arising from the unique risk characteristics and features of the Licensees, which may not be adequately addressed in existing international accounting standards.*

**9.4 Materiality**

9.4.1 Licensees shall disclose information that is material in the sense that its omission or
misstatement could influence a user relying on that information for the purpose of making economic and legitimate assessments or decisions in accordance with Shari’a requirements or international best practices. A qualitative judgement based on user information needs and Shari’a requirements will be an appropriate benchmark of materiality.

9.5 Proprietary and Confidential Information

9.5.1 Proprietary information encompasses information (for example on products or systems), that if shared with competitors would render a Licensee’s investment in these products/systems less valuable, and hence would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what the Licensees should reveal in terms of information about their customer base, as well as details on their internal arrangements, for instance methodologies used, parameter estimates, data, etc. The Central Bank believes that the requirements set out in Article 9.8 strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.

9.6 Validation

9.6.1 The disclosures should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. In addition, supplementary material (such as Management’s Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g. internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand-alone report or as a section on a website, then the management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principle set out below.

9.6.2 In the light of the above, Pillar 3 disclosures will not be required to be audited by an external auditor, unless otherwise required by the applicable accounting standard or the Capital Market Authority (CMA) or the Central Bank standards.

9.7 General Disclosure Principle

9.7.1 Licensees shall have a formal disclosure policy, which is approved by their board of directors. The disclosure policy will address the Licensees’ approach for determining what
disclosures they will make and the internal controls over the disclosure process. In addition, Licensees shall implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

9.7.2 The scope of disclosures shall be commensurate and consistent with the risk assessment and risk management objectives, policies and practices of the Licensees.

9.7.3 In a manner consistent with, and complementary to, other standards set by the Central Bank (such as those on corporate governance and risk management), this standard shall focus on financial, risk and governance disclosures to enable market participants to assess the different categories and the overall level of risk in the Licensee, the extent of risk-sharing and Displaced Commercial Risk borne by shareholders, the practice of smoothing returns on profit-sharing investment accounts and the resultant risk-return mix for IAHs.

9.7.4 Such disclosures can address one of the fundamental issues in risk management in Islamic finance, which is the recognition and measurement of risks associated with PSIA, where Licensees commingle the funds of unrestricted IAHs with their own (shareholders’) funds. This places particular emphasis on retail investor oriented disclosures of risks, as well as returns to IAH.

9.7.5 Scope of Disclosure and Frequency

9.7.6 Licensees, including consolidated banking groups, should provide all Pillar 3 disclosures, both qualitative and quantitative, as at end December each year along with the annual financial statements. Domestically incorporated banks could make interim disclosures on quantitative aspects, on a stand-alone basis, on their websites. Qualitative disclosures that provide a general summary of a Licensee’s risk management objectives and policies, reporting system and definitions may be disclosed on an annual basis.

9.7.7 Pillar 3 applies at the top consolidated level of the Islamic Banking group to which the Framework applies. Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank. An exception to this arises in the disclosure of Total and Tier 1 Capital ratios by the top consolidated entity where an analysis of significant bank subsidiaries within the group is appropriate, in order to recognize the need for these subsidiaries to comply with the Framework and other applicable limitations on the transfer of funds or capital within the group. Pillar 3 disclosures will be required to be made by the Licensees on a standalone basis when they are not the top consolidated entity in the Islamic Banking group.

9.7.8 In recognition of the increased risk sensitivity of the Framework and the general trend towards more frequent reporting in capital markets, all domestic Islamic banks must
disclose their Tier 1 capital, total capital, total required capital and Tier 1 Capital and total capital adequacy ratios on a quarterly basis. Further, the information on risk exposures, which are prone to rapid changes, should also be disclosed at quarterly intervals.

9.7.9 Product- or retail investor- oriented disclosures not periodic in nature but linked to the introduction of new products or modifications to existing products shall be published on a timely basis.

9.7.10 In all cases, material information shall be published as soon as practicable while meeting the deadlines set by the disclosure requirements of the Central Bank.

9.8 Range of Disclosures

9.8.1 *The range of disclosures that the Licensees should comply with, as part of Pillar 3 standards is indicated below:*

9.8.2 Scope of Application

| Qualitative Disclosures | 1. | The name of the ultimate holding corporate entity (or parent entity) in the group to which this disclosure framework is applied, with an indication of whether it is an Licensee or a Conventional Bank with an Islamic Window operation to which the framework is applicable. |
| | 2. | An outline of differences in the bases of consolidation for financial reporting and for regulatory purposes, with a brief description of the entities within the group (a) that are fully consolidated; (b) that are pro-rata consolidated; (c) that are given a deduction treatment; and (d) from which surplus capital is recognised; plus (e) that are neither consolidated nor deducted (for example, where the investment is risk weighted). This specifically applies to full-fledged Islamic Banking subsidiaries. In the case of Islamic Window operations, a separate set of financial statements is to be disclosed in the notes. |
| | 3. | Any restrictions or other impediments on the transfer of funds or regulatory capital within the group. |
| Quantitative | 4. | The aggregate amount of capital deficiencies |
### Disclosures

| 5. | The aggregate amount of capital deficiencies (in relation to the regulatory capital) in all subsidiaries not included in the consolidation, and the name(s) of such subsidiaries. |
| 6. | The aggregate current book value of the firm’s total interests in Takaful entities, whether consolidated or not. |

#### 9.8.3 Capital Structure

#### 9.8.3.1 Disclosures of total and Tier 1 capital by the top consolidated entity, equity of unrestricted IAH and the related prudential reserves of the IAHs shall be made. These disclosures are recommended in view of the potential of IAHs to share in losses and thereby serve as a form of equity. Both qualitative and quantitative disclosures are set out in the table below.

More detailed disclosures on IAHs are presented in Article 9.8.5

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1.</th>
<th>Summary descriptive information on the types, forms, terms and conditions of the main features of all capital- and equity-related capital instruments and unrestricted investment accounts.</th>
</tr>
</thead>
</table>
| Quantitative Disclosures | 2. | The amount of Tier 1 capital, with separate disclosure of:  
- issued and paid-up share capital of the Licensee, and any changes since the last reporting financial year;  
- reserves;  
- minority interests in the equity of subsidiaries;  
- any capital- and equity-related capital instruments that are eligible for inclusion in Tier 1 capital;  
- surplus capital from Takaful companies; |
and

- other reserves.
- Shareholdings equal to or exceeding 5% of the total paid-up capital.

3. The total amount of Tier 2 capital

4. Total eligible capital

5. The amount of unrestricted IAH funds

6. Profit equalisation reserve (PER) (shareholders’ and IAH components) and investment risk reserve (IRR)

9.8.4 Capital Adequacy

9.8.4.1 Capital adequacy determination for Licensees differs from conventional financial institutions in that: (a) its financing arrangements are either asset-based or profit- and loss-sharing (Musharaka), or profit-sharing and loss-bearing (Mudaraba) and (b) much of the funding is raised through unrestricted investment accounts that are, in principle, a form of equity. As such, the underlying assets involved under the Shari’a compliant financing contracts may be exposed to market (price) risk, as well as to credit risk in respect of the amount due from the counterparty. Risk-weighted assets financed by PSIA shall, in principle, be excluded in the calculation of the denominator of the capital ratio, insofar as the commercial risk of these assets does not affect the shareholders’ capital. In practice, however, a proportion of these RWA, or even the full amount, may be subject to a capital requirement, depending upon the extent of risk-sharing between shareholders and unrestricted IAHs.

9.8.4.2 Disclosures in relation to a Licensee’s capital adequacy requirements for different risk categories according to types of assets (which are created from various Shari’a compliant financing contracts), assigning risk weights to such assets, and the adjustment undertaken to the capital requirements for the risks shared with unrestricted IAHs, shall be disclosed.

9.8.4.3 The recommended disclosures are set out in the table below.

| Qualitative Disclosures | 1. | A summary discussion of the Licensee’s approach to assessing the adequacy of its capital to support current and future activities. |
2. A description of policy on identifying RWA funded by unrestricted investment accounts (if any).

3. Capital requirements for:
   a) credit risk;
   b) market risk; and
   c) operational risk.

4. Capital adequacy ratio (CAR)

5. Ratio of total and Tier 1 capital to total RWA.

6. Ratio of total capital to total assets.

7. Disclosure of capital requirements according to different risk categories (credit risk and market risk) for each category of Shari’a compliant financing contract.

8. Disclosure of DCR.

9.8.5 Disclosures for IAH

9.8.5.1 IAH engage in funding of Licensees’ activities typically on a profit-sharing and loss-bearing basis as Rabb al-Mal (investor) under a Mudaraba contract. The underlying Mudaraba contract that governs the relationship between the account holders and the Licensee would require specific disclosures pertaining to their rights to profits and associated risks. Disclosure of information on policies, procedures, product design/type, profit allocation basis and differences between restricted and unrestricted IAH are pertinent to provide clarity and transparency regarding the rates of return and associated risks that are applicable to PSIA. Furthermore, industry- or Licensee-specific policies on maintaining appropriate reserves to manage IAH returns also affect the risk-return mix facing IAH.

9.8.5.2 Since the majority of IAH are likely to be unsophisticated retail investors seeking a Shari’a compliant alternative to conventional deposits, Licensees shall be encouraged to provide simplified disclosures, using simple language and easy-to-understand measures of risk and risk-sharing, and complement it with participation in industry- or supervisor-led investor (and consumer) education efforts.

9.8.5.3 Licensees shall make disclosures of the policies, procedures, product design, product type and profit allocation basis of investment accounts. Such disclosures shall address any
differences between restricted and unrestricted IAH, and the role of various reserves and other policies that may be used to manage the rates of return and the risks associated with PSIA. These disclosures shall also be consistent with the applicable disclosures for the CIS that operate based on Shari’a rules and principles.

9.8.5.4 The disclosures indicated may be made as part of the periodic external financial reporting process (marked “F” in Article 9.8.5.5, 9.8.5.6, 9.8.5.7), or as part of product information published in connection with new products or changes in existing products – for example, prospectuses and offer documents (marked “P” in Tables 9.8.5.5, 9.8.5.6 and 9.8.5.7). Some disclosures may be made under both headings.

9.8.5.5 Investment Accounts (both Unrestricted and Restricted IAH)

<table>
<thead>
<tr>
<th>General Qualitative Disclosures</th>
<th>F</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong> Written procedures and policies applicable to the investment accounts, including a synopsis of the following: range of investment products available from the Licensee; characteristics of investors for whom various investment accounts may be appropriate; purchase, redemption and distribution procedures; experience of portfolio managers, investment advisors and trustees; governance arrangements for the IAH funds; procedures for trading and origination of assets.</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td><strong>2</strong> Disclosure that IAHs funds are invested and managed in accordance with Shari’a requirements.</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td><strong>3</strong> Product information and the manner in which the products are made available to investors.</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>
### General Quantitative Disclosures

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<tbody>
<tr>
<td><strong>4</strong></td>
<td><strong>Bases of allocation of assets, expenses and profits in relation to IAHs funds.</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>5</strong></td>
<td><strong>Disclosure on the policies governing the management of both unrestricted and restricted IAH funds, which covers the approaches to the management of investment portfolio, establishment of prudential reserves, and the calculation, allocation and distribution of profits.</strong></td>
<td><strong>√</strong></td>
</tr>
</tbody>
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<tbody>
<tr>
<td><strong>6</strong></td>
<td><strong>PER-to-PSIA ratio – that is: Amount of total PER / Amount of PSIA by type of IAH.</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>7</strong></td>
<td><strong>IRR-to-PSIA ratio – that is: Amount of total IRR / Amount of PSIA by type of IAH.</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>8</strong></td>
<td><strong>Return on assets (ROA) – that is: Amount of total net income (before distribution of profit to unrestricted IAH) / Total amount of assets financed by shareholders’ equity and minority interests, Unrestricted IAH, and current accounts and other liabilities</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>9</strong></td>
<td><strong>Return on equity (ROE) – that is, Amount of total net income (after distribution of profit to IAH) / Amount of shareholders’ equity.</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>10</strong></td>
<td><strong>Ratios of profit distributed to PSIA by type of IAH.</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td><strong>11</strong></td>
<td><strong>Ratios of financing to PSIA by type of IAH.</strong></td>
<td><strong>√</strong></td>
</tr>
</tbody>
</table>

### Unrestricted Investment Accounts

<p>| | | |</p>
<table>
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</thead>
<tbody>
<tr>
<td><strong>9.8.5.6</strong></td>
<td><strong>Unrestricted Investment Accounts</strong></td>
<td></td>
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</tbody>
</table>

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<table>
<thead>
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<tbody>
<tr>
<td><strong>Additional</strong></td>
<td><strong>General investment objectives and policies that are offered to the unrestricted IAH</strong></td>
<td><strong>√</strong></td>
</tr>
<tr>
<td>Qualitative Disclosures</td>
<td>F</td>
<td>P</td>
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<tr>
<td>----------------------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>based on the general business strategy and risk-sharing policies of the Licensee (including commingling of funds).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Disclosure on the major changes in the investment strategies that affect the investment accounts (including commingling of funds).</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>3 Method for calculation and distribution of profits.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>4 Rules governing the transfer of funds to or from PER and IRR.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>5 Bases applied for charging expenses to unrestricted IAH.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>6 Description of total administrative expenses charged to unrestricted IAH.</td>
<td></td>
<td>√</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Additional Quantitative Disclosures</th>
<th>F</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 Total amount of unrestricted IAH funds, and sub-totals by asset category.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>8 Share of profits earned by unrestricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested).</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>9 Share of profits paid out to unrestricted IAH, after transfers to or from reserves (amount and as a percentage of funds invested).</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>10 Movements on PER during the year.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>11 Movements on IRR during the year.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>12 Disclosure of the utilisation of PER and/or IRR during the period.</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>13 Profits earned and profits paid out over the</td>
<td>√</td>
<td></td>
</tr>
</tbody>
</table>
### Past three to five years (amounts and as a percentage of funds invested).

<table>
<thead>
<tr>
<th></th>
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<th>F</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>Amount of total administrative expenses charged to unrestricted IAH.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Average declared rate of return or profit rate on unrestricted PSIA by maturity (3-month, 6-month, 12-month, 36-month).</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Changes in asset allocation in the last six months.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Off-balance sheet exposures arising from investment decisions, such as commitments and contingencies.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Disclosure of limits imposed on the amount that can be invested in any one type of asset.</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

#### 9.8.5.7 Restricted Investment Accounts

<table>
<thead>
<tr>
<th></th>
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<th>F</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Additional Qualitative Disclosures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Written policies on the Licensee’s fiduciary duties in managing IAH funds.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Investment objectives and policies applicable to the restricted IAH based on their specific investment portfolio.</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>3</td>
<td>Disclosure of the duties and obligations of investment account managers in managing the IAH funds.</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Written policies and procedures for monitoring fiduciary duties and regulatory obligations of the investment account managers.</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>5</td>
<td>Method for calculation and distribution of</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td></td>
<td></td>
<td>F</td>
<td>P</td>
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<tr>
<td>profits.</td>
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</tr>
<tr>
<td>6</td>
<td>If applicable, rules for the transfer of amounts to and from PER and IRR, including contractual or regulatory limits on management’s discretion in the matter.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Amount of restricted IAH funds for each fund with sub-totals by asset category.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Share of profits earned by restricted IAH, before transfers to or from reserves (amount and as a percentage of funds invested).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Share of profits paid out to restricted IAH after transfers to or from reserves (amount and as a percentage of funds invested).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Movements of PER during the year, if applicable.</td>
<td></td>
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<tr>
<td>11</td>
<td>Movements of IRR during the year, if applicable.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Disclosure of the computation of PER and/or IRR, if applicable.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Disclosure of the utilisation of PER and/or IRR, if applicable.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Current period returns.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Historical returns over the past three to five years.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Average declared rate of return or profit rate on restricted PSIA by maturity (3-month, 6-month, 12-month, 36-month).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Off-balance sheet exposures arising from investment decisions, such as commitments and contingencies.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
9.8.6 Retail Investor-Oriented Disclosures for IAH

9.8.6.1 Licensees are encouraged to provide simplified disclosures in plain language in the prospectus or stakeholder reports so that investors are provided with comprehensible and balanced information on which to base their investment decisions. Such retail investor-oriented disclosures shall be designed to be readily accessible and reasonably easy to understand by investors who are not financial professionals. This will enable them to monitor the Licensee’s performance as well as that of the fund managers, thereby contributing to market discipline.

9.8.6.2 Some of these disclosures will be specifically concerned to explain comprehensively, but in non-technical language, the risk-return characteristics of products such as restricted and unrestricted PSIA, including:

9.8.6.2.1 for unrestricted PSIA, the extent to which the Licensee is committed by its policies to maintaining the IAHs investors’ capital intact and to paying a competitive rate of return by accepting DCR;

9.8.6.2.2 the management fee (Mudarib share) as a percentage of the total investment profit, and the extent to which it is subject to partial or total waiver in order to pay a competitive rate of return to IAHs;

9.8.6.2.3 IAHs rights to withdraw funds during the term of the Mudaraba contract, and any penalties, if permissible, such as forfeited shares of profits, that will be incurred by so doing;

9.8.6.2.4 the extent of management’s right to appropriate IAH’s share of investment profits in order to build up PER and/or IRR, to use these reserves to smooth profit payouts to IAHs, and the disposition of unused balances on these accounts at the end of the relevant Mudaraba contract;

9.8.6.2.5 investment and asset allocation policies for IAHs funds, including, with particular reference to unrestricted IAHs, the commingling of their funds with other funds managed by the Licensee, the balance between shareholders’ and IAHs interests in terms of allocating investment funds and the risk-return characteristics of investments;
9.8.6.2.6 for unrestricted IAHs, the extent of any sharing of profits from the Licensee’s provision of fee-based banking;

9.8.6.2.7 the availability of “personal banking” and investment advisory and financial planning services for the benefit of IAHs, and the degree of independence of such advisors in recommending products offered by other Licensees; and

9.8.6.2.8 complaint procedures available to dissatisfied IAHs.

9.8.6.3 Retail investor-oriented disclosures for IAHs (IAHs disclosures) shall contain true, factual and balanced statements, and not projections or estimates of future performance of the funds. These disclosures shall include all explanations, qualifications, limitations and other statements that are necessary to prevent the performance information from misleading investors.

9.8.6.4 IAHs disclosures shall contain information to reflect, at an appropriate level of detail, the direct and indirect fees, expenses, taxes deducted and the net amount receivable by the IAHs based on the profit calculation and allocation methods adopted by the Licensee.

9.8.6.5 In addition to the current period’s performance information, the disclosures shall contain information on historical returns for IAHs and shareholders compared to general market and asset returns, and the underlying profit calculation and allocation method(s) which are consistent over a reasonable comparative period to enable IAHs to make performance comparisons and to evaluate risks.

9.8.7 Risk Management, Risk Exposures and Risk Mitigation

9.8.7.1 General Disclosures: Risk Exposures and Assessment

9.8.7.2 The risks to which the Licensees are exposed, and the techniques they use to identify, measure, monitor and control those risks, are important factors which market participants consider in their assessment of a Licensee.

9.8.7.3 In this Article, several key financing risks are considered: credit risk, equity investment risk, liquidity risk, rate of return risk, market risk and operational risk as specified in the IFSB’s Guiding Principles of Risk Management for Islamic Banks. In addition, some disclosures on credit risk mitigation, DCR and facility-specific risks are peculiar to a Licensee.

9.8.7.4 For each separate risk area, a Licensee shall describe its risk management objectives, policies and practices, the structure and organisation of the relevant risk reporting and measurement systems, measures and indicators of risk exposures, policies for hedging
and/or mitigating risk, and strategies and processes for monitoring the continuing effectiveness of risk management tools and techniques such as hedging and other risk mitigants.

### 9.8.7.5 General Disclosures

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1.</th>
<th>A description of the Licensee’s risk management objectives, strategies, policies and procedures by risk category or in aggregate.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.</td>
<td>Structure and organisation supporting the relevant risk management framework and functions.</td>
</tr>
<tr>
<td></td>
<td>3.</td>
<td>Scope and nature of the risk measurement and reporting system.</td>
</tr>
<tr>
<td></td>
<td>4.</td>
<td>Policies and practices for mitigating risks, including monitoring the continuing effectiveness of risk mitigants.</td>
</tr>
<tr>
<td>Quantitative Disclosures</td>
<td>5.</td>
<td>Disclosure of the range and measures of risks facing each restricted IAH fund, based on its specific investment policies.</td>
</tr>
<tr>
<td></td>
<td>8.</td>
<td>Composition of financing by type of contract as a percentage of total financing.</td>
</tr>
<tr>
<td></td>
<td>9.</td>
<td>Percentage of financing for each category of counterparty to total financing – that is, amount of financing extended to a category of counterparties (outstanding) / amount of total financing (outstanding) x 100.</td>
</tr>
<tr>
<td></td>
<td>10.</td>
<td>Disclosure of the carrying amount of any assets pledged as collateral (excluding amounts pledged to the Central Bank) and the terms and conditions relating to each pledge.</td>
</tr>
</tbody>
</table>
11. The amount of any guarantees or pledges given by the Licensee and the conditions attached to those guarantees or pledges.

9.8.7.6 Credit Risk

9.8.7.6.1 Credit risk is defined as the possibility that the counterparty fails to meet its obligations in accordance with agreed terms in relation to financing, trading, hedging, settlement or other financial transactions. This definition is applicable to a Licensee managing the financing exposures of receivables and leases (for example, Murabaha, Diminishing Musharaka, Ijarah).

9.8.7.6.2 Credit risk is also associated with non-traded equity instruments, such as those based on Mudaraba and Musharaka contracts, which are held for investment purposes and not for trading. The capital invested through Mudaraba and Musharaka may be used to purchase shares in a publicly traded company or privately held equity or investment in a specific project portfolio or through a pooled investment vehicle. In any case, both are profit-sharing financings, under which the capital invested by the provider of finance does not earn a fixed return, but is explicitly exposed to impairment of capital in the event of losses. The capital impairment risk on such equity holdings is treated as part of credit risk.

9.8.7.6.3 A Licensee shall make disclosures of information that reflect its overall credit exposure, the distribution or percentage of credit risk exposures by segments including contract, counterparty, geography, and industry, as well as the quality of its assets overall and by sectors.

9.8.7.6.4 Credit Risk

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1.</th>
<th>A description of the Licensee’s credit risk management policies and objectives.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.</td>
<td>Risk management structure.</td>
</tr>
<tr>
<td></td>
<td>3.</td>
<td>Disclosure of the names of external credit assessment institutions (ECAI) used for the purpose of assigning risk weights to assets.</td>
</tr>
<tr>
<td></td>
<td>4.</td>
<td>Disclosure of definitions of past due receivables and impaired financial assets, and policies and practices for making loss provisions on financial assets.</td>
</tr>
</tbody>
</table>
### Quantitative Disclosures

5. Total gross credit exposures and average gross credit exposures during the previous year and over the period in terms of geographical area, counterparty and industry, and residual contractual maturity for each class of Islamic financing assets, giving the percentages funded by the Licensee’s own capital and current accounts and by PSIA, respectively.

6. Total gross credit exposures and average gross credit exposures during the previous year and over the period by rating categories, where applicable.

7. Total gross exposure and average gross exposure to equity based financing structures by type of financing contract during the previous year and over the period.

8. Amount of past due and impaired financing assets, as well as specific and general loss provisions, classified by counterparty, industry and significant geographic areas, for each class of Islamic financing assets.

9. Disclosure of the amount and changes in loss provisions during the financial year.

10. Disclosure of any penalty imposed on customers for default, and the disposition of any monies received as penalties.

### Credit Risk Mitigation

9.8.7.1 Licensees shall make disclosures regarding credit risk mitigation techniques that have been recognised for the purposes of reducing capital requirements.

### Qualitative Disclosures

1. Disclosure of use of collateral and other Shari’a-compliant risk mitigation techniques together with related policies for assets leased under Ijarah Muntahiyah Bitamleek.
2. A description of the main types of collateral and other credit risk mitigants taken by the Licensee, such as Hamish Jiddiyah, Urbun, PSIA, pledged assets, Sukuk and guarantees by third parties.

3. Disclosure of the policies and processes for valuation of collateral and for ensuring its enforceability, together with related policies and processes for assets leased under Ijarah Muntahiyah Bittamleek. When the assets are not readily convertible into cash by the Licensee, the policies for disposing of the assets, or for using them in the Licensee’s operations, shall be disclosed.

4. Where a third party guarantee is taken as a risk mitigant, the risk weight applicable to the guarantor shall be disclosed.

<table>
<thead>
<tr>
<th>Quantitative Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Disclosure of the total carrying amounts by type of collateral of any assets held as collateral by the Licensee (including any haircuts) and the terms and conditions relating to the pledges.</td>
</tr>
</tbody>
</table>

6. Disclosure of the carrying amount of assets owned and leased under Ijarah Muntahiyah Bittamleek.

9.8.7.8 Liquidity Risk

9.8.7.8.1 A Licensee shall make disclosures regarding its liquidity management framework, on an overall basis, and separately by categories of funding and financing. The recommended disclosures are set out in table below.

9.8.7.8.2 Liquidity Risk

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. A summary of the liquidity risk management framework in addressing risk exposure for each category of funding as well as on an aggregate basis:</td>
</tr>
<tr>
<td>• current accounts;</td>
</tr>
<tr>
<td>• unrestricted investment accounts; and</td>
</tr>
<tr>
<td>• restricted investment accounts.</td>
</tr>
</tbody>
</table>
### General Information on Policies to Address Liquidity Risk

2. General information on policies to address liquidity risk, taking into account the ease of access to Shari’a compliant funds, diversity of funding sources, in case of windows arrangements in place to ensure Shari’a compliant funding to cover liquidity deficit.

### Quantitative Disclosures

3. Indicators of exposures to liquidity risk such as short-term assets to short-term liabilities, liquid asset ratios or funding volatility.

4. Maturity analysis of financing and various categories of funding (current account, unrestricted investment account and restricted investment account) by different maturity buckets.

### Market Risk

9.8.7.9 A Licensee shall make disclosures regarding its framework for market risk management in respect of all assets held for sale, including those that do not have a ready market and/or are exposed to high price volatility.

9.8.7.9.1 Disclosure of appropriate framework for market risk management, including reporting, in respect of all assets held for sale, including those that do not have a ready market and/or are exposed to high price volatility.

### Qualitative Disclosures

1. Indicators of exposures to market risk, such as:
   - breakdown of market RWA by:
     - equity position risk in the trading book and market risk on trading positions in Sukuk;
     - foreign exchange risk; and
     - commodity risk;
   - foreign exchange net open positions to capital;
   - commodity net open positions to capital; or
   - equity net open positions to capital.

2. Total amounts of assets subject to market risk by type of assets.
|   | Measures of value-at-risk or other sensitivity analyses for different types of market risk, such as;  
|   | • foreign exchange risk;  
|   | • commodity price risk; and  
|   | • potential losses due to movements in market rate of return, benchmark rates or equity prices.  

### 9.8.7.10 Operational Risk

#### 9.8.7.10.1
Licensees are exposed to a range of operational risks that could materially affect their operations. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including losses resulting from Shari’a non-compliance and the failure in fiduciary responsibilities of the Licensee towards different fund providers. Failure of these controls may affect the soundness of the Licensee’s operations and its reliability of reporting.

#### 9.8.7.10.2
A Licensee shall make disclosures regarding its systems and controls, including those for Shari’a compliance, and the mechanisms it has in place to safeguard the interests of all fund providers.

#### 9.8.7.10.3 Operational Risk

| Qualitative Disclosures | 1. Policies to incorporate operational risk measures into the management framework – for example, budgeting, target-setting and performance review and compliance.  
|  |  
|   | 2. Policies on processes; (a) to help track loss events and potential exposures; (b) to report these losses, indicators and scenarios on a regular basis; (c) to review the reports jointly by risk and line managers; and (d) to ensure Shari’a compliance  
|   | 3. Policies on the loss mitigation process via contingency planning, business continuity planning, staff training and enhancement of internal controls, as well as business processes and infrastructures.  
5. Indicators of operational risk exposures, such as:
   • gross income; and
   • amount of Shari’a non-compliant income

9.8.7.11 Rate of Return Risk

9.8.7.11.1 “Rate of return risk” refers to the possible impact on the net income of the Licensee arising from the impact of changes in the market rates and relevant benchmark rates on the return on assets and on the returns payable on funding. This impact arises from the unrestricted IAHs funds being invested in fixed-return assets such as Murabaha, when the IAHs expect a return reflecting current market conditions. An increase in benchmark rates (or market rates) may result in IAHs having expectations of a higher rate of return, while the returns on assets may be adjusting more slowly due to longer maturities, thereby affecting net income to the Licensee during any reference period. Rate of return risk differs from interest rate risk in that the Licensees are concerned with the returns on their investment activities at the end of the investment-holding period and with the impact on net income after the sharing of returns with IAHs. In contrast, in measuring interest rate risk, the cost of funding is contractually independent of the return on assets.

9.8.7.11.2 Insofar as IAHs share in the profits and bear the losses on investments and related operations of the Licensees, any impact on the return on assets will be offset, at least in part, by the corresponding adjustments in the return payable on IAHs funds. The extent to which IAHs share the risks will depend on the Licensee’s policies to absorb part of the risks that would otherwise be borne by IAHs under a Mudaraba contract. Thus the greater the absorption of risks by the Licensee (known as DCR), the greater the likely magnitude of the rate of return risk.

9.8.7.11.3 A Licensee shall make disclosures, both qualitative and quantitative, of factors that cause rate of return risk and some indicators of this risk, including data on maturity gaps, and on the sensitivity to changes in market rates of the returns on various Shari’a compliant financing contracts and of the returns payable to the various sources of funding. Disclosures of risks and returns for investment accounts, and the related disclosures on DCR below, are also relevant in assessing the rate of return risk.

9.8.7.11.4 Rate of Return Risk

| Qualitative Disclosures | 1. Discussion of factors affecting rates of return and benchmark rates, and the effects thereof on the pricing of contracts. |
2. Processes and systems to monitor and measure (including frequency of measurement) the factors that give rise to the rate of return risk

<table>
<thead>
<tr>
<th>Quantitative Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Indicators of exposures to rate of return risk – for example, data on expected payments/receipts on financing and funding and the cost of funding at different maturity buckets according to time of maturity or time of re-pricing for floating rate assets or funding.</td>
</tr>
<tr>
<td>4. Sensitivity analysis of the Licensee’s profits and the rate of return to price or profit rate movements in the market.</td>
</tr>
</tbody>
</table>

9.8.7.12 Displaced Commercial Risk

9.8.7.12.1 “Displaced commercial risk” refers to the magnitude of risks that are transferred to shareholders in order to cushion the IAH from bearing some or all of the risks to which they are contractually exposed in Mudaraba funding contracts. Under a Mudaraba (profit-sharing and loss-bearing) contract, in principle, unrestricted IAH are exposed to the aggregate impact of risks arising from the assets in which their funds are invested, but they benefit from the DCR assumed by the Licensee. This risk-sharing is achieved by constituting and using various reserves such as PER, and by adjusting the Mudarib’s (Licensee as fund manager) profit share in order to smooth the returns payable to the IAH from exposure to the volatility of aggregate returns arising from banking risks, and thereby to enable payment of returns that are competitive in the marketplace. Such transfer of risks (and returns) from IAH to shareholders requires inclusion of a proportion of the RWA funded by IAH in the denominator of the CAR.

9.8.7.12.2 “PER” refers to reserves set aside from Mudaraba profits before applying the profit-sharing distribution; hence, part of the PER is a component of shareholders’ equity and the remainder is a component of the equity of IAH. The use of PER may help to smooth the rates of return paid to IAH and (as dividends) to shareholders. In particular, the use of the PER may be combined with the Licensee giving up a part or all of its Mudarib share of profits, in order to smooth the profit payout to IAH so as to match prevailing market returns (IAH’s opportunity cost). Such a profit payout to IAH shall be distinguished from the unadjusted Mudaraba outcome, with the profits being shared according to the agreed contractual ratios, and with no smoothing of the returns paid to unrestricted IAHs.

9.8.7.12.3 IRR is a reserve set aside from the part of profits allocated to IAHs based on the applicable
Islamic Banking Regulatory Framework

profit share. Such a reserve belongs to IAHs and may be used only to absorb losses (other
than those due to misconduct or negligence) during a financial period. In any case,
information on variability of aggregate Mudaraba profits, the size and use of PER and IRR
and of profits distributed after the utilisation of these reserves, is of prime importance in
determining the risk-return mix facing the IAH and the size of DCR assumed by the
Licensee.
9.8.7.12.4 A Licensee shall disclose the framework, policy and practices for managing the risk of
return mix of the IAHs and the resulting DCR, and provide indicators that enable the
stakeholders to assess the aggregate risks facing the IAHs and the extent of risks
transferred to the Licensee.
Qualitative 1.
Disclosures

2.

Disclosure of the Licensee‟s policy on DCR, including the
framework for managing the expectations of its
shareholders and unrestricted IAHs, the sharing of risks
among the various stakeholders, and the range and
measures of risks facing unrestricted IAHs based on the
Licensee‟s general business strategies and investment
policies.
Disclosure of historical data over the past five years:
• total Mudaraba profits available for sharing between
unrestricted IAHs and shareholders (as Mudarib) as a
percentage of Mudaraba assets;
• Mudaraba profits earned for unrestricted IAHs (as a
percentage of assets) before any smoothing;
• Mudaraba profits paid out to unrestricted IAHs (as a
percentage of assets) after any smoothing;
•
•
•
•

3.

Title 5 – Capital Adequacy

balances of PER and IRR, and movements on these in
determining unrestricted IAH payout;
variations in Mudarib‟s agreed profit-sharing ratio
from the
contractually agreed ratio; and
market benchmark rates.

Five-year comparison of historical rate of return of
unrestricted IAH in relation to the market benchmark rate.

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9.8.7.13 Contract-specific Risks

9.8.7.13.1 Each type of Islamic financing asset is exposed to a varying mix of credit and market risks. This mix can also vary according to the stage of the contract. Accordingly, it is appropriate to monitor the total risk exposure in each type of financing asset and the corresponding capital charge for each type.

9.8.7.13.2 Contract-specific Risks

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1.</th>
<th>Policy on relative shares of various Shari’a compliant financing contracts and capital allocation for various types of Shari’a compliant financing contracts.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantitative Disclosures</td>
<td>2.</td>
<td>Total RWA classified by type of Shari’a-compliant financing contract.</td>
</tr>
</tbody>
</table>
9.8.8 General Governance and Shari’a Governance Disclosures

9.8.8.1 Disclosures of general and Shari’a governance are designed to provide information on the structure, processes and functioning of such governance in a Licensee. An important objective of these disclosures is to ensure transparency regarding Shari’a compliance by the Licensee.

9.8.8.2 International standards, codes and best practices of corporate governance, such as Principles of Corporate Governance issued by the OECD, and Enhancing Corporate Governance for Banking Organisations issued by the Basel Committee on Banking Supervision, and other relevant governance standards are congruent with these aims and, where relevant, complementary in terms of guidance for appropriate disclosures.

9.8.8.3 A Licensee shall make disclosures of the structure, processes and functioning of its general and Shari’a governance. Such disclosures shall include the rights of IAHs, compliance with Shari’a rules and principles and transparency of financial reporting in respect of investment accounts.

9.8.8.4 General Governance Disclosures

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1. Disclosure and explanation of any departure from complying with the applicable financial reporting standards.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. Disclosure of the Licensee’s corporate governance arrangements and practices, including whether the Licensee complies in full with the Corporate Governance Standard set by CBO for Islamic banks and CMA for publicly listed companies.</td>
</tr>
<tr>
<td></td>
<td>3. Disclosure of any related party transactions and treatment of material events by the Licensee.</td>
</tr>
<tr>
<td></td>
<td>4. Disclosure of any investor/consumer education programmes for information on new products and services.</td>
</tr>
<tr>
<td></td>
<td>5. Information on mediation and advice bureaus for investors and customers set up by the Licensee, including clearly written procedures for lodging of complaints.</td>
</tr>
<tr>
<td></td>
<td>Disclosure of social functions and charitable contributions of the Licensee, such as Zakah, Qard, Sadaqah, etc.</td>
</tr>
<tr>
<td>---</td>
<td>----------------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>

9.8.8.5 Shari’a Governance Disclosures

<table>
<thead>
<tr>
<th>Qualitative Disclosures</th>
<th>1. A statement on the governance arrangements, systems and controls employed by the Licensee to ensure Shari’a compliance and on how these meet the standards set by CBO, and if there is less than full compliance with desirable standards, an explanation of the reasons for non-compliance.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. Disclosure of how Shari’a non-compliant earnings and expenditures occur and the manner in which they are disposed of.</td>
</tr>
<tr>
<td></td>
<td>3. Disclosure of whether compliance with Shari’a rulings is mandatory or not.</td>
</tr>
<tr>
<td>Quantitative Disclosures</td>
<td>4. Disclosure of the nature, size and number of violations of Shari’a compliance during the year.</td>
</tr>
<tr>
<td></td>
<td>5. Disclosure of annual Zakah contributions of the Licensee, where relevant, according to constitution, general assembly or national requirements or as required by the respective SSB.</td>
</tr>
<tr>
<td></td>
<td>6. Remuneration of Shari’a board members.</td>
</tr>
</tbody>
</table>

9.9 Treatment of Islamic Windows

9.9.1 For the purposes of this title, an Islamic Window operation is defined as part of a conventional financial institution (which may be branch/es of that institution) that provides both fund management (investment accounts) and financing and investment services that are Shari’a compliant. In principle, these Windows are potentially self-contained in terms of Shari’a compliant financial intermediation, as the funds managed will be invested in Shari’a compliant assets.

9.9.2 As an identifiable unit within a conventional financial institution that provides a complete intermediation process, from sourcing funds to providing finance, the Islamic Window is deemed to be responsible to its fund providers (current account holders and IAHs) in the
same way as a full-fledged Islamic Bank. Disclosure requirements as per this Title shall therefore apply to an Islamic Window, as defined in this Title.

9.9.3 Subject to the materiality criteria as indicated in this Title, a complete set of financial statements with notes for an Islamic Window shall be provided as part of the notes to the financial statements of the conventional financial institution of which the window is a part. It is required that this or an equivalent practice be followed by all institutions having Islamic Window operations as defined for the purpose of this Title.

9.9.4 If the institution’s accounting system is not designed to produce information for the Window as required, hereunder, any requisite changes to the institution’s accounting system will need to be made.

9.9.5 The institution shall comply with disclosure requirements that relate to the risk management of the Shari’a compliant assets and the appropriate risk weightings of those assets for capital adequacy purposes. Such disclosure requirements also apply to holdings of Sukuk.

9.9.6 In addition, information on the appropriate mechanism established to provide Shari’a oversight of the activities of an Islamic Window, as recommended in the Title on General Obligations and Governance shall be disclosed.
10. **Recommended Minimum Procedures for Disclosure Requirements under Pillar 3**

10.1 **Introduction**

10.1.1 *Pillar 3 disclosure requirements are provided under Article 9. Further, modalities of disclosure requirements have been discussed in this section.*

10.1.2 The Central Bank has evolved a draft audit report for the ‘agreed upon procedure’ and recommended ‘standardized procedures for carrying out the agreed upon procedure’, which are enclosed. Licensees are advised to ensure that the Pillar 3 disclosure requirements are subjected to an ‘agreed upon procedure’ by their external auditors, in line with the enclosed documents.

10.1.3 Licensees shall implement recommended standardized procedures to be performed in respect of Pillar 3 Disclosures.

10.1.4 The suggested procedures are applicable to Licensees adopting standardized approach for credit and market risk and basic indicator approach for operational risk.

10.1.5 The procedures given hereunder are applicable to large banks and are to be suitably modified for smaller banks depending on the scale, size and complexity of the business.

10.1.6 The recommended standardized procedures for external auditors are illustrated below:

10.2 **General Disclosure Principle**

10.2.1 External Auditors can validate the general disclosure principle referenced in Article 9.7 by obtaining and reading the “Disclosure policy” established by the Licensee and checking that:

10.2.1.1 it is approved by the Board of Directors by tracing the Board Resolution ratifying the disclosure policy;

10.2.1.2 it addresses the Licensee’s approach for determining what disclosures the Licensee will make; and

10.2.1.3 it sets out the internal controls over the disclosure process.

10.2.2 They should:

10.2.2.1 perform a test-check and / or walk-through of the internal controls set out in the policy.
10.2.2.2 discuss with management the processes implemented at the Licensee to assess the appropriateness of the disclosures and document the frequency of updates.

10.2.2.3 enquire with the management about the materiality threshold referenced in Article 9.4, followed for disclosure purposes and discuss the basis used for setting out such threshold.

10.2.2.4 enquire as to whether the thresholds are used internally by the Licensee for risk management purposes (use test).

10.3 **Range of Disclosures - Scope of Application**

10.3.1 External auditors can validate the scope of application referenced in Article 9.8.2 through the following procedures:

10.3.2 Check that in the case of a banking group the name of the top corporate entity in the group to which the framework applies is properly disclosed on the Pillar 3 Report (the Report).

10.3.3 Check that in the case of a banking group, management outlines in the Report the differences in the basis of consolidation for accounting and regulatory purposes.

10.3.4 Check that the management has disclosed a brief description of the following with respect to the banking group in the Report:

10.3.4.1 entities that are fully consolidated;

10.3.4.2 entities that are pro-rata consolidated;

10.3.4.3 entities that are given a deduction treatment;

10.3.4.4 entities from which surplus capital is recognised; and

10.3.4.5 entities that are neither consolidated nor deducted

10.3.5 Such information normally includes (a) name of the entity; (b) the country of incorporation; (c) shareholding percentage owned by the group; (d) other major shareholders; (e) the principal activities of the entity; (f) the entity’s total assets; (g) the capital adequacy ratio (if applicable); and (h) any short fall in capital with respect to the entity’s regulatory capital requirements.

10.3.6 Trace the aggregate amount of capital deficiencies in all subsidiaries not included in the consolidation (i.e. that are not deducted) that is disclosed in the Report to the respective subsidiaries’ audited financial statements.

10.3.7 Trace the aggregate amount aggregate current book value of the firm’s total interests in
insurance Takaful entities, whether consolidated or not.

10.4 **Range of Disclosures - Capital Structure**

10.4.1 External auditors can validate the disclosures related to capital structure detailed in Article 9.8.3 through the following procedures:

10.4.2 Check that the report includes a summary on the terms and conditions of the main features of all capital instruments.

10.4.3 Check completeness of this information by tracing the capital instruments as disclosed in the audited financial statements to the Report.

10.4.4 Trace the individual items shown as Tier 1 capital to the audited financial statements.

10.4.5 Check that the following items are separately disclosed in the calculation:

10.4.5.1 issued and paid-up share capital of the Licensee, and any changes since the last reporting financial year;

10.4.5.2 reserves;

10.4.5.3 minority interests in the equity of subsidiaries;

10.4.5.4 any capital- and equity-related capital instruments that are eligible for inclusion in Tier 1 capital;

10.4.5.5 surplus capital from insurance Takaful companies; and

10.4.5.6 other reserves.

10.4.6 Shareholdings equal to or exceeding 5% of the total paid-up capital.

10.4.7 Trace the balances of the above items used for the deduction from Tier 1 and Tier 2 capital to the audited financial statements.

10.4.8 Trace the constituent elements making up Tier 2 capital to the audited financial statements.

10.4.9 Enquire with management regarding the basis of deductions from capital further to the above.

10.4.10 Check the current level of restricted and unrestricted funds from IAH.

10.4.11 Check the balance of PER and IRR reserves. Trace the account balances and account movements.

10.4.12 Enquire the management regarding the basis of arriving at the current level of reserves.
10.4.13 Check the mathematical accuracy of the information provided for Tier 1 capital, Tier 2 capital, PER and IRR.

10.4.14 Verify that the limits prescribed for various capital elements are not breached.

10.4.15 Review the summary for any possible omission by reference to the audited financial statements.

10.5 Range of Disclosures - Capital Adequacy

10.5.1 External auditors can validate the disclosures related to capital adequacy detailed in Article 9.8.4 through the following procedures:

10.5.2 Check that the Report includes a summary discussion of the Licensee’s approach to assessing the adequacy of its capital to support current and future activities. This information would normally be included as a separate section/paragraph in the Report.

10.5.3 Enquire with management regarding the Licensee’s strategy in implementing capital adequacy guidelines, including advanced approaches. Check these factors are included in the Report.

10.5.4 Satisfy itself over the gross balances and the net balances of the following items as shown in the calculation table of the capital adequacy ratios:

10.5.4.1 on balance sheet items;

10.5.4.2 off-balance sheet items;

10.5.5 Enquire whether the Licensee has exercised its discretion in choosing the rating agencies for different asset classes and necessary approvals have been obtained from the Central Bank. Check if these ratings are used for the risk management purposes as well.

10.5.6 Satisfy itself over the gross balances and net balance of each Islamic contract type.

10.5.7 Ensure that Licensee has applied adequate care in identifying the varying nature of risk within the contract life cycle.

10.5.8 Ensure that counterparty for each contract is identified and classified to one of the appropriate categories in Article 4.2.

10.5.9 For Murabaha based contracts, wherever the Licensee is not carrying a market risk charge, ensure that they have secured adequate Promise to Purchase (PP). Enquire with the management their procedures to ensure contracts are recorded correctly.
10.5.10 For Salam based contracts ensure those receivable amounts are captured accurately. Ensure that market risk charge is calculated according to Article 3.3 in the absence of a Parallel Salam.

10.5.11 Ensure that Credit Risk charge is be applied from the date of the contract made between both parties until the maturity of the Salam contract, which is upon receipt of the purchased commodity.

10.5.12 For limited and Non Recourse Istisna’a ensure the accuracy of risk weights calculated through the supervisory slotting criteria. Ensure that work in progress (WIP) is appropriately captured. Ensure accuracy of market risk charged calculated on unbilled WIP and credit risk charge for billed WIP.

10.5.13 Ensure that Credit Risk charge is applied from the date when the manufacturing or construction process commenced and until the selling price is fully settled by the Licensee, either in stages and/or on the maturity of the Istisna’a contract, which is upon delivery of the manufactured asset to the Istisna’a ultimate buyer.

10.5.14 For Ijarah and IMB ensure that market risk charge is calculated in the absence of a Promise to Lease (PL).

10.5.15 Discuss with management to ensure that adequate procedures are followed ensure that PL are legally enforceable.

10.5.16 Check the mathematical accuracy of calculation of estimated Ijarah receivable amount.

10.5.17 For Musharaka based contracts understand from management the procedures that are followed for profit and loss sharing. Ensure accuracy of calculation of profits.

10.5.18 Ensure accuracy of classification of Musharaka into various categories. Check the overall balances under each category of Musharaka.

10.5.19 Ensure accuracy of risk weights when they are calculated according to the supervisory slotting criteria.

10.5.20 When Musharaka contracts are used together with other Ijarah or Murabaha sub contracts, ensure RW are assigned based on the credit standing of the counterparty/lessee, as rated by an ECAI that is approved by the Central Bank.

10.5.21 For Mudaraba based contracts understand from management the procedures that are followed for profit sharing and loss bearing. Ensure accuracy of calculation of profits and loss distribution.
10.5.22 Ensure accuracy of classification of Mudaraba into various categories. Check the overall balances under each category of Mudaraba.

10.5.23 Ensure accuracy of risk weights when they are calculated according to the supervisory slotting criteria.

10.5.24 For Claims on Sovereigns, check that the risk-weights for the individual Claims on Sovereigns are computed in terms of Article 4.2.

10.5.25 Check that the risk weights prescribed by the host country supervisors are taken into account correctly.

10.5.26 Enquire with management whether management has used the consensus country risk classification of OECD for assigning risk weights.

10.5.27 For Claims on (a) domestic Public Sector Entities (PSEs); and (b) Claims on Securities firms (including finance and leasing companies – FLCs), check if the risk weights used by management are on the same lines as corporates.

10.5.28 Test will be conducted by comparing a sample of risk weights used in the computation for PSEs and Claims on Securities to the weights used for corporates.

10.5.29 Check that entities treated by management as Multilateral Development Banks (MDBs) having a risk weight of 0% are featured in the list included Article 4.2.4.1.

10.5.30 Enquire with management whether claims on MDBs other than those listed in Section 4.2.4.1 are based on external credit assessments as for banks but without the possibility of using preferential treatment for short-term claims. For a sample of such instances, trace the weights used by management to external credit assessments for banks.

10.5.31 Check that the risk weights assigned by management to Claims on Banks are those included in the table in Article 4.2.5 by comparing a sample of weights used by management to the weights as per the table.

10.5.32 For claims on an unrated bank, check that the risk weight is not lower than that applied to claims of its sovereign of incorporation. In such cases, the following also apply for facilities that are not expected to be rolled over:

10.5.32.1 A preferential risk weight that is one category more favorable should be applied to claims with an original maturity of 3 months or less subject to a floor of 20%;

10.5.32.2 A risk weight that is one category less favorable than that assigned to claims on the sovereign, subject to a floor of 20% should be assigned to claims on banks of an original...
maturity of 3 months or less and denominated and funded in the domestic currency.

10.5.33 Test this by selecting a sample of unrated banks and compare the weights used by management to the weights to be used for the respective banks’ sovereign of incorporation.

10.5.34 For Claims on Corporate, check that management has used the weights included in the table in Article 4.2.8.

10.5.35 For claims on any unrated corporate check that the risk weight used by management is not lower than the risk weight of its sovereign of incorporation by comparing the weights used by management on a sample of such claims and agreeing the weights to the respective sovereign of incorporation.

10.5.36 If the Licensee opts to risk weight all claims on corporates at 100% irrespective of external credit ratings, check if the Licensee has obtained prior approval to do so by the Central Bank – and retain a copy of such approval.

10.5.37 Enquire with management whether such practice is consistently followed for all corporate claims.

10.5.38 Discuss with management the basis used by management to identify claims that are included in the Regulatory Retail Portfolios, the basis for which shall meet the criteria as set out in Section 4.2.9.

10.5.39 Trace the total of the categories that meet the criteria indicated in 4.2.9.1.1 to 4.2.9.1.4 above to the Licensee’s MIS and review the reconciliation between such reports and the audited financial statements for these items.

10.5.40 Discuss with management how they satisfy themselves that the risk weight of 75% is only applied to that portion of the Regulatory Retail Portfolio that meets the criteria described in Article 4.2.9.

10.5.41 Test the above by tracing a sample of the claims included in the Regulatory Retail Portfolio to the underlying facilities files. For each of the criteria obtain reports by management generated through the MIS detailing the individual claims included in the Regulatory Retail Portfolio and which show compliance with the above criteria.

10.5.42 Check that all other retail financing including small business financing is risk weighted at 100% by tracing a sample of such financing to the underlying facility files.

10.5.43 Check the mathematical accuracy of the risk weight calculation and trace the totals to the Report.
10.5.44 For Claims Secured by Residential Property, discuss with management that in applying the risk weight of 35%, the management has considered the criteria in Article 4.2.10.

10.5.45 Test the above classification for a sample of claims shown in the Claims Secured by Residential Property portfolio.

10.5.46 The Claims Secured by Commercial Real Estate shall be risk weighted at 100% in accordance with article 4.2.11.

10.5.47 Obtain a list of the non-performing assets (financing) and agree the total of the list to the audited financial statements and/or BOSS reports. The list should include the secured and unsecured portion of the non-performing assets and should include the amount of specific provision and reserved profit.

10.5.48 Check that management has used the following risk weights on the unsecured portion of any financing classified as non-performing and which is not covered by the specific provision and reserved profit (the net exposure) by test-checking a sample of non-performing financing and review management’s calculation:

10.5.48.1 150% when the specific loan loss provision is less than 25% of the outstanding amount, net of reserved profit;

10.5.48.2 100% when the specific loan loss provision is not less than 25% of the outstanding amount, net of reserved profit;

10.5.49 Check that the following claims are risk weighted at 150% or more:

10.5.49.1 claims on Sovereigns and banks rated below B-;

10.5.49.2 claims on corporates rated below BB-; and

10.5.49.3 real estate and personal property acquired in satisfaction of debts previously contracted and banks have been carrying such assets for more than 12 months from the date of acquisition.

10.5.50 Test the above by tracing a sample of such instruments to the computation tables and comparing the risk weight used to 150%.

10.5.51 Check that Sukuk tranche is deducted from the capital base by obtaining a list of such facilities and scrutinizing the risk weights used by the management.

10.5.52 In those cases where the Licensee has considered collateral in determining the provision for bad debts, perform the following:

10.5.52.1 enquire with management how it establishes legal certainty of the collateral, including how management has satisfied itself of the legal mechanism by which collateral is pledged or
transferred grants the bank the right to liquidate, or take legal possession of it, in a timely manner, in the event of default or bankruptcy (or other credit event defined by the Licensee in the financing documents);

10.5.52.2 enquire with management how the Licensee takes all steps necessary to fulfil the legal requirements applicable to the Licensee’s interest in the collateral for obtaining and maintaining an enforceable security interest. Appropriate persons to enquire would be the Legal Officer and the Head of Risk Management;

10.5.52.3 enquire with the Head of Risk Management how the Licensee ensures that the credit quality of the counterparty and the value of the collateral do not have a material positive correlation;

10.5.52.4 obtain and read the Licensee’s policies and procedures with respect to the treatment of collateral. Check that the policies and procedures address the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed and that the collateral can be liquidated promptly.

10.5.52.5 in those cases where the collateral is held by a custodian, enquire with management how the Licensee satisfies itself that the custodian segregates the collateral from its own assets.

10.5.53 Obtain a list of collateral instruments used by the Licensee as credit risk mitigants. The list should be stratified by type of collateral. Check that the list of collateral only includes the instruments by comparing the contents of the list provided by the management to the allowed collaterals listed in Article 4.4.13.

10.5.54 Verify whether the Licensee has exercised the option for the appropriate collaterals approach either simple or comprehensive and if it has the Central Bank’s permission for the selected approach.

10.5.55 If the Licensee uses the Comprehensive Approach, check that the Licensee complies with the provisions set out in Article 4.4. Particularly, perform the following:

10.5.55.1 test the mathematical accuracy of the computation of exposure amount after risk mitigation as per the formula set out in section 4.4 for a sample of collateralized transactions;

10.5.55.2 test on a sample basis the risk weights used by the Licensee by tracing these to the risk weights and the haircuts set out in Article 4.4.17.

10.5.56 Where guarantees are taken into account by the Licensee in calculating capital requirements for risk weighted assets, test on sample basis by reference to the source documents that
evidence exists to support the conclusion that:

10.5.56.1 guarantees are issued by an entity with a lower risk weight than the counterparty’s;
10.5.56.2 guarantees are irrevocable;
10.5.56.3 guarantees are unconditional;
10.5.56.4 guarantees represent a direct claim on the provider; and
10.5.56.5 guarantees are explicitly referenced to specific exposures or a pool of exposures.

10.5.57 Enquire and discuss with management whether the exposure deemed protected has been determined in accordance with conditions set out in Article 4.4.7 where guarantees are used to reduce exposures for capital adequacy calculation and if they are denominated in a currency other than that in which the exposure is denominated.

10.5.58 Enquire and discuss whether claims guaranteed by the Government of the Sultanate of Oman or the Central Bank, where exposure and guarantee both are denominated in Rial Omani, are assigned a 0% risk weight. Trace a sample of such cases to the workings underlying the Report and check that these have a risk weight of 0%.

10.5.59 Enquire and discuss with management whether the Licensee has multiple CRM techniques. In such cases check that exposure is subdivided into the portion covered by each type of CRM techniques by tracing such subdivided analysis in the Report.

10.5.60 Agree “capital requirements for credit risk” to total credit risk weighted assets, “capital requirements for market risk” to total market risk weighted assets, “capital requirements for operational risk” to total operational risk. Check the mathematical accuracy in arriving at the total risk weighted assets. Check the computation of the capital adequacy ratio.

10.6 Range of Disclosures – Disclosures for IAH

10.6.1 Ensure that the Licensee has adequate policies in place for governing IAH funds. Discuss with the management to verify the processes followed for managing IAH funds.

10.6.2 Ensure that the Licensee has in place formal Shari’a structures to allocate assets, expenses and profits in relation to IAH funds. Enquire and discuss with the management the process followed by the Licensee for allocating assets, expenses and profits to IAH.

10.6.3 Ensure mathematical accuracy of IAH funds, PER and IRR balances.

10.6.4 Test the mathematical accuracy of calculation of various ratios described in section 9.8.5.
10.6.5 Ensure that the Licensee has in place formal rules related to transfer of funds from and to PER and IRR.

10.6.6 Ensure the mathematical accuracy of total expenses allocated to unrestricted and restricted IAH.

10.6.7 Ensure that the Licensee has in place a formal policy for its fiduciary responsibilities to restricted IAH. Discuss with the management and ensure adequate internal controls exist to protect the interests of restricted IAH.

10.6.8 Review the method of calculation and distribution of profits. Test the mathematical accuracy of these calculations.

10.6.9 Test the mathematical accuracy of balance of restricted IAH and profits attributable to restricted IAH.

10.7 Range of Disclosures – Retail Investor Oriented Disclosures

10.7.1 The disclosures specific to retail investors are disclosures which have already been made part of one or more of the above Articles. The auditors should ensure that these disclosures do not contradict with other disclosures.

10.8 Range of Disclosures - Risk Exposure and Assessment

10.8.1 Enquire and discuss with management the risk management objectives and policies adopted by the Licensee and check that these are included in the credit risk – general disclosures paragraph. The following shall be disclosed:

10.8.1.1 Strategies and processes;

10.8.1.2 The structure and organisation of the relevant risk management function;

10.8.1.3 The scope and nature of risk reporting and/or measurement systems;

10.8.1.4 Policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/ mitigants;

10.8.1.5 Definition of past due and impaired (for accounting purposes);

10.8.1.6 Description of approaches followed for specific and general provisions; and

10.8.1.7 Statistical methods used, if any.

10.8.2 Satisfy itself with the balances contained in the summary for computing average gross
exposure and total gross exposure with the Licensee’s records and audited financial statements for the current and previous years.

10.8.3 Satisfy itself with the geographical distribution of the exposures and their breakdown with the audited financial statements and/or Licensee’s books and records.

10.8.4 Satisfy itself with the industry wise or counterparty wise distribution of exposures by major types of credit with the audited financial statements and Licensee’s books and records.

10.8.5 Satisfy itself with residual contractual maturity breakdown of (i) whole portfolio and (ii) by major types of credit exposure to the audited financial statements and/or Licensee’s records.

10.8.6 Satisfy itself with the totals of the industry wise or counterparty wise exposures; analyzed into gross financing, their classification, provision for impairment, reserve profit and financing written off during the year with the audited financial statements and / or Licensee’s records.

10.8.7 Reconcile the classified financing for regulatory purposes and accounting purposes.

10.8.8 Satisfy itself with the amount of impaired and past due financing (if any), specific and general allowances related to geographical area to the audited financial statements and / or Licensee’s records.

10.8.9 Satisfy itself with details of performing and non-performing assets (financing) and the movement of gross financing and advances with the audited financial statements and / or Licensee’s records.

10.8.10 Review the summary for any possible omission by reference to the audited financial statements.

10.8.11 Satisfy itself with the balances for the components disclosed in the summary to the audited financial statements and Licensee’s records.

10.8.12 Range of disclosures - Credit Risk

10.8.12.1 In respect of qualitative disclosure, check that the following information is disclosed:

10.8.12.1.1 Names of ECAIs used, plus reasons for any changes over prior periods.

10.8.12.1.2 Types of exposure for which each agency is used.

10.8.12.1.3 A description of the process used to transfer public issue ratings onto comparable assets in the banking book.
10.8.12.1.4 Check that only those ECAIs prescribed under Article 4.3.3 were used by the Licensee.

10.8.12.1.5 Check that for exposure amounts after mitigation, amount of Licensee’s outstanding portfolio (rated and unrated) in each risk bucket as well as those that are deducted is disclosed.

10.8.12.1.6 Check the mathematical accuracy of the summary and agree the balance related to each component to the audited financial statements and Licensee’s records.

10.8.13 Range of disclosures - Credit risk mitigation

10.8.13.1 Enquire and discuss the general qualitative disclosure requirement with respect to credit risk mitigation which includes the following:

10.8.13.1.1 Policies and procedures, and an indication of the extent to which the Licensee makes use of on- and off- balance sheet netting.

10.8.13.1.2 Policies and processes for collateral valuation and management.

10.8.13.1.3 A description of the main types of collateral taken by the Licensee.

10.8.13.1.4 The main types of guarantor, counterparty and their creditworthiness.

10.8.13.1.5 Information about (market or credit) risk concentrations within the mitigation taken.
Satisfy itself with details of collaterals for the financing given to the audited financial statements and Licensee’s records.

Enquire and discuss the general qualitative disclosure for market risk including the portfolios covered by the standardized approach.

Satisfy itself with the quantitative disclosures in respect of capital requirement for (i) rate of return risk; (ii) equity position risk; (iii) commodity position risk and (iv) foreign exchange risk to the audited financial statements and Licensee’s records.

Check the Licensee’s calculations of specific market rate risk both specific and general risk charges.

Enquire whether all fixed income securities and other profit rate related instruments in the trading book have been included.

Check the calculation of specific and general market risk for equity position;

Check the calculation of capital charge for foreign exchange position;

Check the calculation of capital charge for commodity risk;

Check the accuracy of aggregation of capital charge for market risk;

Check that the capital charge has been converted into risk weighted assets correctly.

Check that the liquidity management policy is approved by the Board of Directors and includes the following:

Contingency plan;

Frequency of liquidity management.

Read the Licensee’s liquidity management policy:

Enquire with management regarding the consistency of the policy with the overall risk management framework of the Licensee;

Obtain a reconciliation of the maturity analysis of the assets and liabilities with IFRS amounts and check the mathematical accuracy of the statement;

Satisfy itself with the balances to the audited financial statements of the Licensee.
10.8.16 Range of disclosures – Operational risk

10.8.16.1 Read the Licensee’s operational risk management policy. Review the qualitative disclosure used in the report for operational risk and determine whether this is in agreement with the Licensee’s policy.

10.8.16.2 Satisfy itself with the balance of gross income used for calculating capital charge for operational risk to the audited financial statements.

10.8.16.3 Check the mathematical accuracy of the calculation for capital charge on operational risk.

10.8.16.4 Obtain approval of the Licensee’s report by the Board of Directors and retain a copy of such Board resolution.

10.8.16.5 Obtain written representations from the Board of Directors regarding the completeness and accuracy of the disclosures set out in the Report.

10.8.16.6 Obtain the latest Central Bank examination report in respect of their annual examination and check that findings impacting the disclosures to be made are included in the Report.

10.8.16.7 Discuss findings arising from above procedures with the responsible personnel of the implementation of Pillar 3.

10.8.16.8 Consider whether any content of the disclosures are:

10.8.16.8.1 internally inconsistent with other parts of the disclosures;

10.8.16.8.2 in respect of narrative items, inconsistent with numerical data in the disclosures;

10.8.16.8.3 inconsistent with the audited financial statements of the Licensee.
10.8.16.9 Check whether any internal audit reports have been issued to date in respect of the process and internal controls related to preparing the disclosures and / or over the underlying data. If issued, obtain a copy and scrutinize.

10.8.17 Range of disclosures – Displaced Commercial Risk

10.8.17.1 Review the Licensee policy for displaced commercial risk. Discuss with the management to understand displacement of commercial risk followed at the Licensee.

10.8.17.2 Review and ensure the mathematical accuracy of calculation of portfolio risk weight after incorporating the effects of DCR.

10.8.18 Range of disclosures – Contract specific disclosures

10.8.18.1 Satisfy itself with the balance reported under each contract.

10.8.19 General Governance and Shari’a Governance Disclosures

10.8.19.1 The external auditors should ensure that the General Governance disclosures are endorsed by the Board and the Shari’a disclosures are endorsed by the SSB of the Licensee.
11. Attachment

11.1 Guidelines on the Capital Adequacy Report under Basel II

(Some of the provisions may not be entirely applicable on Islamic Banks and Windows due to their unique nature)

Introduction

1. The format for Capital Adequacy Report is given below. The formats contain a working sheet for computing the risk-weighted assets pertaining to banking book, a worksheet for computing the risk weighted assets pertaining to trading book and operational risk. The summary sheet captures the data on capital elements, risk-weighted assets and the capital adequacy ratio.

2. The data collected by the Central Bank in the formats are high-level aggregated data and banks shall maintain the detailed worksheets for the respective reporting periods so as to enable the on-site examiners to verify the accuracy and correctness of the reported figures with reference to the underlying data. A reconciliation between category-wise claims reported under the Capital Adequacy Report and the category-wise claims as per the financials may also be prepared and retained for the scrutiny of the Central Bank examination team.

3. All the figures reported in the format should be rounded off to 000’s and without any decimals. Capital adequacy ratio may be indicated with one decimal. The position as obtained on the last working day of the reporting quarter shall be reported.

4. As a general rule, in completing the return formats, banks should assign exposures for which credit protection is provided by another counterparty (e.g. in the form of guarantee) and that are subject to the substitution approach according to the characteristics of the provider of protection. Thus, if a bank has an exposure to a corporate guaranteed by another bank, this exposure must be treated as a bank exposure and included in the claims on the Licensee portfolio.

Banking Book Worksheet

5. Broad categories under which the credit risk exposures in banking book are to be reported are given in the format. While determining the category under which an exposure is to be reported, the characteristics of protection provider are to be considered. Under drawn exposure, outstanding balance is to be indicated. Undrawn exposures would include commitments (e.g. formal standby facilities and credit lines) and are to be entered after applying the appropriate credit conversion factors. Where the undrawn exposure is an off-balance sheet exposure, lower of the two applicable CCFs may be applied.

6. Total exposure column should tally with the aggregate of the columns ‘drawn exposure’, ‘undrawn exposure’, and ‘other OBS’. Under ‘unsecured’ column the portion of the total exposure that is not secured should be indicated. Under the ‘Pre-mitigation’ column, the remaining portion of the total exposure, after deducting the unsecured portion, is to be
indicated. The sum of columns ‘unsecured’ and ‘pre-mitigation’ should tally with the ‘total exposure’ column. The total of ‘unsecured’ column and ‘post-mitigation’ column should tally with that of ‘net exposure’ column

7. Under the ‘post-mitigation’ column, exposures reported under ‘pre-mitigation’ column after adjusting the value of collaterals and the impact of guarantees and other credit protection are to be reported. Where the amount guaranteed or against which credit protection is held, is less than the amount of the exposure, and the secured and unsecured portions of equal seniority, capital relief will be afforded on a proportional basis i.e. the protected portion of the exposure will receive the treatment applicable to eligible guarantees / credit derivatives, with the remainder treated as unsecured. For example, a loan exposure of RO. 1 million with a bank guarantee for RO 500,000 would be reported as 1 million under ‘total exposure’, 500,000 under ‘unsecured’, 500,000 under ‘pre-mitigation’, 0 under ‘post mitigation’ and 500,000 under ‘net exposure’ column. Where a bank has multiple CRM techniques covering a single exposure (e.g bank having both collateral and guarantee partially covering an exposure) the Licensee will be required to subdivide the exposure into positions covered by each type of CMR technique and the risk weighted assets of each portion must be calculated separately.

8. RWAs – standardized approach is to be computed by multiplying the net exposure by the risk weight. RWAs – current is to be computed on the basis of the existing capital adequacy framework and indicated for each category separately.

9. The off-balance sheet exposures pertaining to different claims are to be reported under respective categories of claims. Bank’s own position in the off-balance sheet exposures may be reported under the category ‘Off-balance sheet items’.

Trading Book worksheet:

10. The capital charge on market risk is for meeting both specific risk as well as general market risk. The methodology for computing both specific risk charge as well as the general market charge is detailed in the guidelines. Banks that do not have a trading book, except the foreign exchange open position need to fill in only rows 2(iii), 3 and 4 in the format.

Operational Risk worksheet

11. Banks are required to compute the capital charge for operational risk under the Basic Indicator Approach. For this purpose, gross income is to be computed strictly on the basis of the definition provided in the Basel II guidelines. It may be noted that interest reserved during the year should not be added to the gross income. However, reserved interest realized in cash during the year shall be added to the gross income. Average gross income should be multiplied by 15% to get the capital charge. The equivalent risk weighted assets are to be computed by multiplying the capital charge with a factor of 12.5.

Summary Sheet:

12. The elements of capital are to be indicated in the sheet ‘Elements of Capital’. The break-up of tier I capital and tier II capital are to be furnished as per the format.
13. The summary sheet is to be filled as under:

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Indication</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Indicate the amount of Tier I Capital after adjusting for deductions in terms of para 31 of the Basel II guidelines.</td>
</tr>
<tr>
<td>2</td>
<td>Indicate the amount of Tier II Capital after adjusting for deductions in terms of para 31 of the Basel II guidelines.</td>
</tr>
<tr>
<td>3</td>
<td>Risk Weighted Assets – Banking Book – Indicate the total risk weighted assets as computed under the sheet ‘Computation of Risk Weighted Assets – Banking Book’.</td>
</tr>
<tr>
<td>4</td>
<td>Risk Weighted Assets – Operational Risk – Indicate the total risk weighted assets as computed under the sheet ‘Risk weighted assets – operational risk’.</td>
</tr>
<tr>
<td>5</td>
<td>Indicate the total of amounts indicated under Sl.No.3 &amp; Sl.No.4</td>
</tr>
<tr>
<td>6</td>
<td>Minimum required capital to support RWAs of banking book and operational risk is 12% of the RWAs as indicated under Sl.No.5.</td>
</tr>
<tr>
<td>7(i)</td>
<td>Minimum required Tier I Capital for banking book &amp; operational risk:</td>
</tr>
<tr>
<td></td>
<td>► First consider the Tier II capital as indicated under Sl.No.2. If the a) Tier II capital is less than 50% of amount indicated under Sl.No.8, then the amount to be indicated under 8(i) = Sl.No.8 – Sl. No. 2</td>
</tr>
<tr>
<td></td>
<td>► If the Tier II capital is more than 50% of amount indicated under b) Sl.No.8, indicate under 7(i), 50% of the amount indicated under Sl.No.7.</td>
</tr>
<tr>
<td>7(ii)</td>
<td>Tier II capital required for banking book &amp; operational risk:</td>
</tr>
<tr>
<td></td>
<td>► If the Tier II capital is less than 50% of amount indicated under a) Sl.No.8, then the amount to be indicated under 8(ii) = Amount as shown in Sl. No. 2</td>
</tr>
<tr>
<td></td>
<td>► If the Tier II capital is more than 50% of amount indicated under b) Sl.No.8, indicate under 7(ii), 50% of the amount indicated under Sl.No.8.</td>
</tr>
<tr>
<td>8</td>
<td>Tier I Capital available for supporting Trading Book is to be computed as Sl.No.1 – Sl.No.7(i).</td>
</tr>
<tr>
<td>9</td>
<td>Tier II Capital available for supporting Trading Book is to be computed as Sl.No.2 – Sl.No.7(ii).</td>
</tr>
<tr>
<td>Sl. No.</td>
<td>Description</td>
</tr>
<tr>
<td>--------</td>
<td>-------------</td>
</tr>
<tr>
<td>1</td>
<td>Indicate the amount of Tier I Capital after adjusting for deductions in terms of para 31 of the Basel II guidelines.</td>
</tr>
<tr>
<td>10</td>
<td>Risk Weighted Assets – Trading Book - Indicate the total risk weighted assets as computed under the sheet ‘Risk weighted assets – Trading Book’.</td>
</tr>
<tr>
<td>11</td>
<td>Total capital required to support trading book may be computed as 12% of Sl.No.10</td>
</tr>
<tr>
<td>12</td>
<td>Minimum Tier I Capital required to support the trading book is computed as 28.5% of Sl.No.11</td>
</tr>
<tr>
<td>13</td>
<td>Total Regulatory Capital would be equal to the aggregate of Tier I and Tier II capital.</td>
</tr>
<tr>
<td>14</td>
<td>Total risk weighted assets – whole bank = Sl.No.6 + Sl.No.10</td>
</tr>
<tr>
<td>15</td>
<td>Capital Adequacy Ratio – (Sl.No.13/Sl.No.14)*100</td>
</tr>
<tr>
<td>Sl. No</td>
<td>Details</td>
</tr>
<tr>
<td>--------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1</td>
<td>Tier I Capital (after supervisory deductions)</td>
</tr>
<tr>
<td>2</td>
<td>Tier II capital (after supervisory deductions &amp; upto eligible limits)</td>
</tr>
<tr>
<td>3</td>
<td>Of which, Total Eligible Tier III Capital</td>
</tr>
<tr>
<td>4</td>
<td>Risk Weighted Assets – Banking Book</td>
</tr>
<tr>
<td>5</td>
<td>Risk Weighted Assets – Operational Risk</td>
</tr>
<tr>
<td>6</td>
<td>Total Risk Weighted Assets – Banking Book + Operational Risk</td>
</tr>
<tr>
<td>7</td>
<td>Minimum required capital to support RWAs of banking book &amp; operational risk</td>
</tr>
<tr>
<td></td>
<td>i) Minimum required Tier I Capital for banking book &amp; operational risk</td>
</tr>
<tr>
<td></td>
<td>ii) Tier II Capital required for banking book &amp; operational risk</td>
</tr>
<tr>
<td>8</td>
<td>Tier I capital available for supporting Trading Book</td>
</tr>
<tr>
<td>9</td>
<td>Tier II capital available for supporting Trading book</td>
</tr>
<tr>
<td>10</td>
<td>Risk Weighted Assets – Trading Book</td>
</tr>
<tr>
<td>11</td>
<td>Total capital required to support Trading Book</td>
</tr>
<tr>
<td>12</td>
<td>Minimum Tier I capital required for supporting Trading Book</td>
</tr>
<tr>
<td>13</td>
<td>Used Eligible Tier III Capital</td>
</tr>
<tr>
<td>14</td>
<td>Total Regulatory Capital</td>
</tr>
<tr>
<td>15</td>
<td>Total Risk Weighted Assets – Whole bank</td>
</tr>
<tr>
<td>16</td>
<td>Capital Adequacy Ratio</td>
</tr>
</tbody>
</table>
## Islamic Banking Regulatory Framework

### Exposure with CRM

<table>
<thead>
<tr>
<th>Details</th>
<th>Drawn Exposure</th>
<th>Undrawn Exposure</th>
<th>Other OBS Exposure</th>
<th>Total Exposure</th>
<th>Unsecured Pre-mitigation</th>
<th>Post-mitigation</th>
<th>Net Exposure</th>
<th>RWAs Standardized Approach</th>
<th>RWAs Current</th>
</tr>
</thead>
</table>

### Banking Book

1. **Sovereign**
   - carrying 0%
   - carrying 20%
   - carrying 50%
   - carrying 100%
   - carrying 150%
   - Unrated 100%

2. **MDBs**
   - carrying 0%

3. **Banks**
   - carrying 0%
   - carrying 20%
   - carrying 50%
   - carrying 100%
4) Corporate

- carrying 0%
- carrying 20%
- carrying 50%
- carrying 100%
- carrying 150%
- Unrated 100%

5) Retail

- carrying 0%
- carrying 20%
- carrying 50%
- carrying 75%
- carrying 100%

6) Claims secured by residential property

- carrying 0%
### Islamic Banking Regulatory Framework

<table>
<thead>
<tr>
<th>7) Claims secured by</th>
<th>carrying 0%</th>
<th>carrying 20%</th>
<th>carrying 35%</th>
<th>carrying 100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>commercial property</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>8) Past Due Loans</th>
<th>carrying 0%</th>
<th>carrying 20%</th>
<th>carrying 35%</th>
<th>carrying 100%</th>
<th>carrying 150%</th>
<th>carrying 100%</th>
<th>carrying 50%</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>9) Other Assets</th>
<th>carrying 0%</th>
<th>carrying 20%</th>
<th>carrying 35%</th>
<th>carrying 100%</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>10) High Risk Assets</th>
<th>carrying 0%</th>
<th>carrying 20%</th>
<th>carrying 35%</th>
<th>carrying 100%</th>
</tr>
</thead>
</table>
Islamic Banking Regulatory Framework

Securitisation tranches rated between BB+ and BB- -350%

Venture Capital & Private Equity Investments -150%

Properties acquired in settlement of claims, which are pending for sale for more than one year

11) Off-balance Sheet
   Items
   carrying 0%
   carrying 20%
   carrying 50%
   carrying 100%

12) Failed transactions
   (para 88)
   From 5 to 15 days after the agreed settlement date (100% RWA)
   From 16 to 30 days after the agreed settlement date (625% RWA)
   From 31 to 45 days after the agreed settlement date (937.5% RWA)
   46 days or more after the agreed settlement date (1250% RWA)

Total Banking Book
<table>
<thead>
<tr>
<th>Elements of Capital</th>
<th>Amount in RO 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier I Capital</td>
<td></td>
</tr>
<tr>
<td><strong>Domestic Banks</strong></td>
<td></td>
</tr>
<tr>
<td>1 Paid-up Capital</td>
<td></td>
</tr>
<tr>
<td>2 Share Premium</td>
<td></td>
</tr>
<tr>
<td>3 Legal Reserves</td>
<td></td>
</tr>
<tr>
<td>4 General reserves</td>
<td></td>
</tr>
<tr>
<td>5 Subordinated Loan Reserve</td>
<td></td>
</tr>
<tr>
<td>6 Stock Dividend</td>
<td></td>
</tr>
<tr>
<td>7 Retained Earnings</td>
<td></td>
</tr>
<tr>
<td>8 Non-cumulative perpetual preferred stock</td>
<td></td>
</tr>
<tr>
<td>9 Other non-distributable reserve</td>
<td></td>
</tr>
<tr>
<td><strong>Foreign Banks</strong></td>
<td></td>
</tr>
<tr>
<td>10 Assigned Capital</td>
<td></td>
</tr>
<tr>
<td>11 Capital Deposits</td>
<td></td>
</tr>
<tr>
<td>12 Retained Earnings</td>
<td></td>
</tr>
<tr>
<td>13 Free funds from HO</td>
<td></td>
</tr>
<tr>
<td><strong>Total Gross Tier I Capital</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Deduction**

<table>
<thead>
<tr>
<th>Deduction</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>14 Goodwill</td>
<td></td>
</tr>
<tr>
<td>15 Deferred Tax Asset</td>
<td></td>
</tr>
<tr>
<td>16 Intangible Assets, including losses, cumulative unrealized losses recognized directly in equity</td>
<td></td>
</tr>
<tr>
<td>17 Reciprocal crossholding of bank capital, artificially designed to inflate the capital position of banks</td>
<td></td>
</tr>
<tr>
<td>Elements of Capital</td>
<td>Amount in RO 000s</td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------------</td>
<td>------------------</td>
</tr>
<tr>
<td><em>sub total</em></td>
<td></td>
</tr>
<tr>
<td><strong>18</strong> Tier I capital after the above deductions</td>
<td></td>
</tr>
<tr>
<td><strong>19</strong> 50% of investments in the capital of banks and other financial entities, other than reciprocal cross holdings of bank capital</td>
<td></td>
</tr>
<tr>
<td><strong>20</strong> 50% of Significant minority and majority investments in commercial entities, which exceed 5% of the Licensees’ net worth for individual significant investments and 20% of the Licensees’ net worth for aggregate of such investments</td>
<td></td>
</tr>
<tr>
<td><strong>21</strong> 50% of shortfall in the regulatory capital requirements in the un-consolidated entities</td>
<td></td>
</tr>
<tr>
<td><strong>22</strong> 50% of investments in unconsolidated banking and financial subsidiary companies associates or affiliates, etc</td>
<td></td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td></td>
</tr>
<tr>
<td><strong>23</strong> Tier I capital after all deductions</td>
<td></td>
</tr>
<tr>
<td><strong>Tier II Capital</strong></td>
<td></td>
</tr>
<tr>
<td><strong>24</strong> Undisclosed reserves</td>
<td></td>
</tr>
<tr>
<td><strong>25</strong> Revaluation Reserves/Cumulative fair value gains or losses on available for sale instruments</td>
<td></td>
</tr>
<tr>
<td><strong>26</strong> General Loan Loss Provisions/General Loan Loss Reserve</td>
<td></td>
</tr>
<tr>
<td><strong>27</strong> Subordinated Sukuk (if specific permission from Central Bank)</td>
<td></td>
</tr>
<tr>
<td><strong>28</strong> Hybrid Capital Instruments</td>
<td></td>
</tr>
<tr>
<td><strong>29</strong> Total Tier II Capital</td>
<td></td>
</tr>
<tr>
<td><strong>31</strong> <strong>Total regulatory Capital</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Details-Risk Weighted Assets – Trading Book</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>S. No.</td>
<td>Details - Risk Weighted Assets – Trading Book</td>
</tr>
<tr>
<td>-------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>1</td>
<td>Capital Charge on Specific Risk</td>
</tr>
<tr>
<td></td>
<td>i) On profit rate related instruments</td>
</tr>
<tr>
<td></td>
<td>ii) On Equities</td>
</tr>
<tr>
<td>2</td>
<td>Capital charge on general market risk</td>
</tr>
<tr>
<td></td>
<td>i) On profit rate related instruments</td>
</tr>
<tr>
<td></td>
<td>ii) On Equity</td>
</tr>
<tr>
<td></td>
<td>iii) On foreign exchange &amp; Gold position</td>
</tr>
<tr>
<td></td>
<td>iv) On Commodities position</td>
</tr>
<tr>
<td>3</td>
<td>Total Capital Charge for market risks</td>
</tr>
<tr>
<td>4</td>
<td>Total Risk Weighted Assets – Trading Book</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Details - Risk Weighted Assets – Operational Risk</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Capital Charge for Operational Risk under Basic Indicator Approach</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Total Risk Weighted Assets – Operational Risk</td>
<td>1*12.5</td>
</tr>
</tbody>
</table>
### 11.2 Supervisory Slotting Criteria

**SUPERVISORY SLOTTING CRITERIA FOR ISTISNA’A IN LIMITED AND NON-RECOURSE PROJECT FINANCE AND MUSHARAKA IN A BUSINESS VENTURE**

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financials</strong></td>
<td>- Few competitors or substantial and durable advantage in location, cost, or technology&lt;br&gt;Demand is strong and growing</td>
<td>- Few competitors or better than average location, cost, or technology but this situation may not last&lt;br&gt;Demand is strong and stable</td>
<td>- Project/business venture has no advantage in location, cost, or technology&lt;br&gt;Demand is adequate and stable</td>
<td>- Project/business venture has worse than average location, cost, or technology&lt;br&gt;Demand is weak and declining</td>
</tr>
<tr>
<td><strong>Market conditions</strong></td>
<td>- Strong financial ratios considering the level of project/business venture risk; very robust economic assumptions.</td>
<td>- Strong to acceptable financial ratios considering the level of project/business venture risk; robust project/business venture economic assumptions.</td>
<td>- Standard financial ratios considering the level of project/business venture risk.</td>
<td>- Aggressive financial ratios considering the level of project/business venture risk.</td>
</tr>
<tr>
<td><strong>Financial ratios</strong></td>
<td>- The project/business venture can meet its financial obligations under sustained, severely stressed economic or sectoral conditions</td>
<td>- The project/business venture can meet its financial obligations under normal stressed economic or sectoral conditions. The project/business venture is only likely to default under severe economic conditions</td>
<td>- The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn</td>
<td>- The project/business venture is likely to default unless conditions improve soon</td>
</tr>
<tr>
<td><strong>Stress analysis</strong></td>
<td>- The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn</td>
<td>- The project/business venture is likely to default unless conditions improve soon</td>
<td>- The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn</td>
<td>- The project/business venture is likely to default unless conditions improve soon</td>
</tr>
</tbody>
</table>
### SUPERVISORY SLOTTING CRITERIA FOR \emph{ISTISNA'A} IN LIMITED AND NON-RECOOURSE PROJECT FINANCE AND \emph{MUSHARAKA} IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financing structure</strong></td>
<td>Duration of the contract compared to the duration of the project/ business venture</td>
<td>Useful life of the project/ business venture significantly exceeds tenor of the financing contract</td>
<td>Useful life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Useful life of the project/ business venture may not exceed tenor of the contract</td>
</tr>
<tr>
<td></td>
<td>Usefully life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Usefully life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Usefully life of the project/ business venture exceeds tenor of the financing contract</td>
<td>Usefully life of the project/ business venture may not exceed tenor of the contract</td>
</tr>
<tr>
<td></td>
<td>Usefully life of the project/ business venture may not exceed tenor of the contract</td>
<td>Usefully life of the project/ business venture may not exceed tenor of the contract</td>
<td>Usefully life of the project/ business venture may not exceed tenor of the contract</td>
<td>Usefully life of the project/ business venture may not exceed tenor of the contract</td>
</tr>
<tr>
<td>Payment structure of selling price (Note: applicable to \emph{Istisna'a} only)</td>
<td>Partly in advance and in installments</td>
<td>Installments</td>
<td>Installments with limited bullet payment</td>
<td>Bullet payment or in installments with balloon structure (higher installment amounts towards end of the contract)</td>
</tr>
<tr>
<td>Political and legal environment</td>
<td>Political risk, including transfer risk, considering project/business venture type and mitigants</td>
<td>Very low exposure; strong mitigation instruments, if needed</td>
<td>Low exposure; satisfactory mitigation instruments, if needed</td>
<td>Moderate exposure; fair mitigation instruments</td>
</tr>
<tr>
<td></td>
<td>Force majeure risk (war, civil unrest, etc)</td>
<td>Low exposure</td>
<td>Acceptable exposure</td>
<td>Standard protection</td>
</tr>
<tr>
<td></td>
<td>Standard protection</td>
<td>Significant risks, not fully mitigated</td>
<td>Significant risks, not fully mitigated</td>
<td>Significant risks, not fully mitigated</td>
</tr>
</tbody>
</table>
SUPERVISORY SLOTTING CRITERIA FOR *ISTISNA’A* IN LIMITED AND NON-RECOUSE PROJECT FINANCE AND *MUSHARAKA* IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Political and legal environment (cont’d)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government support and project/business venture's importance for the country over the long term</td>
<td>Project/business venture of strategic importance for the country (preferably export-oriented) Strong support from government</td>
<td>Project/business venture considered important for the country. Good level of support from government.</td>
<td>Project/business venture may not be strategic but brings unquestionable benefits for the country. Support from government may not be explicit.</td>
<td>Project/business venture not key to the country No or weak support from government</td>
</tr>
<tr>
<td>Stability of legal and regulatory environment (risk of change in law)</td>
<td>Favourable and stable regulatory environment over the long term</td>
<td>Favourable and stable regulatory environment over the medium term</td>
<td>Regulatory changes can be predicted with a fair level of certainty</td>
<td>Current or future regulatory issues may affect the project/business venture</td>
</tr>
<tr>
<td>Acquisition of all necessary supports and approvals for such relief from local content laws</td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td>Enforceability of contracts, collateral and security</td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are enforceable</td>
<td>Contracts, collateral and security are considered enforceable even if certain non-key issues may exist</td>
<td>There are unresolved key issues in respect of actual enforcement of contracts, collateral and security</td>
</tr>
</tbody>
</table>
### SUPERVISORY SLOTTING CRITERIA FOR ISTISNA’A IN LIMITED AND NON-RECOourse PROJECT FINANCE AND MUShARAKA IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Transaction Characteristics</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design and technology risk</td>
<td>Fully proven technology and design</td>
<td>Fully proven technology and design</td>
<td>Proven technology and design-start-up issues are mitigated by a strong completion package</td>
<td>Unproven technology and design; technology issues exist and/or complex design</td>
</tr>
</tbody>
</table>

### Construction Risk

<table>
<thead>
<tr>
<th>Permitting and sitting</th>
<th>All permits have been obtained</th>
<th>Some permits are still outstanding but their receipt is considered very likely</th>
<th>Some permits are still outstanding but the permitting process is well defined and they are considered routine</th>
<th>Key permits still need to be obtained and are not considered routine. Significant conditions may be attached</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of construction contract</td>
<td>Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)</td>
<td>Fixed-price date-certain turnkey construction EPC</td>
<td>Fixed-price date-certain turnkey construction contract with one or several contractors</td>
<td>No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors</td>
</tr>
<tr>
<td>Completion guarantees</td>
<td>Substantial liquidated damages supported by financial substance and/or strong completion guarantee from sponsors with excellent financial standing</td>
<td>Significant liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing</td>
<td>Adequate liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing</td>
<td>Inadequate liquidated damages or not supported by financial substance or weak completion guarantees</td>
</tr>
</tbody>
</table>
### SUPERVISORY SLOTTING CRITERIA FOR *ISTISNA'A* IN LIMITED AND NON-RECOOURSE PROJECT FINANCE AND *MUSHARAKA* IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Construction Risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(for project finance only)</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>(cont'd)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Track record and financial</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>strength of contractor in</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>constructing similar project</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>business ventures</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Operating risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scope and nature of operations</td>
<td>Strong long-term O&amp;M</td>
<td>Long-term O&amp;M contract,</td>
<td>Limited O&amp;M contract or</td>
<td>No O&amp;M contract: risk of</td>
</tr>
<tr>
<td>and maintenance (O&amp;M) contracts</td>
<td>O&amp;M contract, preferably</td>
<td>and/or O&amp;M reserve</td>
<td>O&amp;M reserve account</td>
<td>high operational cost overruns</td>
</tr>
<tr>
<td></td>
<td>with contractual performance</td>
<td>accounts</td>
<td></td>
<td>beyond mitigants</td>
</tr>
<tr>
<td></td>
<td>incentives, and/or O&amp;M reserve accounts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operator’s expertise, track</td>
<td>Very strong, or committed</td>
<td>Strong</td>
<td>Acceptable</td>
<td>Limited/weak, or local operator dependent on</td>
</tr>
<tr>
<td>record, and financial strength</td>
<td>technical assistance of the sponsors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>local authorities</td>
</tr>
</tbody>
</table>
### SUPERVISORY SLOTTING CRITERIA FOR ISTISNA’A IN LIMITED AND NON-RECURSE PROJECT FINANCE AND MUSHARAKA IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Off-take risk (for project finance only)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) If there is a take-or-pay or fixed-price off-take contract:</td>
<td>Excellent creditworthiness of off-taker; strong termination clauses; tenor of off-take contract comfortably exceeds the maturity of the financing contract</td>
<td>Good creditworthiness of off-taker; strong termination clauses; tenor of off-take contract exceeds the maturity of the financing contract</td>
<td>Acceptable financial standing of off-taker; normal termination clauses; tenor of off-take contract generally matches the maturity of the financing contract</td>
<td>Weak off-taker; weak termination clauses; tenor of off-take contract does not exceed the maturity of the financing contract</td>
</tr>
<tr>
<td>(b) If there is no take-or-pay or fixed-price off-take contract</td>
<td>Project produces essential services or a product sold widely on a world market; output can readily be absorbed at projected prices even at lower than historic market growth rates</td>
<td>Project produces essential services or a product sold widely on a regional market that will absorb it at projected prices even at historical growth rates</td>
<td>Product is sold on a limited market that may absorb it only at lower than projected rates</td>
<td>Project output is demanded by only one of a few buyers or is not generally sold on an organised market</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Supply risk (for project finance only)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price, volume and transportation risk of feedstocks; supplier's track record and financial strength</td>
<td>Long-term supply contract with supplier of excellent financial standing</td>
<td>Long-term supply contract with supplier of good financial standing</td>
<td>Long-term supply contract with supplier of good financial standing - a degree of price risk may remain</td>
<td>Short-term supply contract or long-term supply contract with financially weak supplier - a degree of price risk definitely remains</td>
</tr>
</tbody>
</table>
SUPERVISORY SLOTTING CRITERIA FOR ISTISNA’A IN LIMITED AND NON-RECOUSE PROJECT FINANCE AND MUSHARAKA IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Supply risk (cont’d)</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve risks (e.g. natural resource development)</td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project</td>
<td>Proven reserves can supply the project adequately through the maturity of the financing contract</td>
<td>Project relies to some extent on potential and undeveloped reserves</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Strength of Sponsor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sponsor's (or partner's, in the case of Musharaka) track record, financial strength, and country/sector experience</td>
</tr>
<tr>
<td>Sponsor (or partner, in the case of Musharaka) support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary</td>
</tr>
</tbody>
</table>

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### SUPERVISORY SLOTTING CRITERIA FOR *ISTISNA’A* IN LIMITED AND NON-RECOUSE PROJECT FINANCE AND *MUSHARAKA* IN A BUSINESS VENTURE

<table>
<thead>
<tr>
<th>Security Package</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assignment of contracts and accounts *</td>
<td>Fully comprehensive</td>
<td>Comprehensive</td>
<td>Acceptable</td>
<td>Weak</td>
</tr>
<tr>
<td>Pledge of assets, taking into account quality, value and liquidity of assets *</td>
<td>First perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Acceptable security arrangement in all project assets, contracts, permits and accounts necessary to run the project</td>
<td>Little security or collateral for NFS; weak negative pledge clause</td>
</tr>
<tr>
<td>NFS’ control over cash flow (e.g. independent escrow accounts)</td>
<td>Strong</td>
<td>Satisfactory</td>
<td>Fair</td>
<td>Weak</td>
</tr>
<tr>
<td>Reserve funds (payment of selling price in <em>Istisna’a</em>, O&amp;M, renewal and replacement, unforeseen events, etc.)</td>
<td>Longer than average coverage period, all reserve funds fully funded in cash</td>
<td>Average coverage period, all reserve funds fully funded in cash</td>
<td>Average coverage period, all reserve funds fully funded in cash</td>
<td>Shorter than average coverage period, reserve funded from operating cash flows</td>
</tr>
</tbody>
</table>

* In *Musharaka*, the collateralisation of underlying assets is restricted to losses arising from negligence and misconduct cases only.
### SUPERVISORY SLOTTING CRITERIA FOR *DIMINISHING MUSHARAKA* IN REAL ESTATE

<table>
<thead>
<tr>
<th>Financial strength</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market conditions</td>
<td>The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is equal or lower than forecasted demand.</td>
<td>The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is roughly equal to forecasted demand.</td>
<td>Market conditions are roughly in equilibrium. Competitive properties are coming on the market and others are in the planning stages. The business venture's design and capabilities may not be state of the art compared to new project/business ventures.</td>
<td>Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium. The business venture is losing tenants at <em>ijarah/lease</em> expiration. New <em>ijarah/lease</em> terms are less favourable compared to those expiring.</td>
</tr>
<tr>
<td>Stress analysis</td>
<td>The property's resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress.</td>
<td>The property can meet its financial obligations under a sustained period of financial stress. The property is likely to default only under severe economic conditions.</td>
<td>During an economic downturn, the property would suffer a decline in revenue that would limit its ability to fund capital expenditures and significantly increase the risk of default.</td>
<td>The property's financial condition is strained and is likely to default unless conditions improve in the near term.</td>
</tr>
</tbody>
</table>
## SUPERVISORY SLOTTING CRITERIA FOR **DIMINISHING MUSHARAKA IN REAL ESTATE**

<table>
<thead>
<tr>
<th>Cash-flow predictability</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>For complete and stabilised property</td>
<td>The property's leases are long-term with creditworthy tenants and their maturity dates are scattered. The property has a track record of tenant retention upon lease expiration. Its vacancy rate is low. Expenses (such as maintenance, insurance, security, and property taxes) are predictable.</td>
<td>Most of the property's leases are long-term, with tenants that range in creditworthiness. The property experiences a normal level of tenant turnover upon lease expiration. Its vacancy rate is low. Expenses are predictable.</td>
<td>Most of the property's leases are medium rather than long-term with tenants that range in creditworthiness. The property experiences a moderate level of tenant turnover upon lease expiration. Its vacancy rate is moderate. Expenses are relatively predictable but vary in relation to revenue.</td>
<td>The property's leases are of various terms with tenants that range in creditworthiness. The property experiences a very high level of tenant turnover upon lease expiration. Its vacancy rate is high. Significant expenses are incurred preparing space for new tenants.</td>
</tr>
<tr>
<td>(b) For complete but not stabilised property</td>
<td>Leasing activity meets or exceeds projection. The business venture should achieve stabilisation in the near future.</td>
<td>Leasing activity meets or exceeds projections. The project should achieve stabilisation in the near future.</td>
<td>Most leasing activity is within projections; however, stabilisation will not occur for some time.</td>
<td>Market rents do not meet expectations. Despite achieving target occupancy rate, cash flow coverage is tight due to disappointing revenue.</td>
</tr>
</tbody>
</table>
### SUPERVISORY SLOTTING CRITERIA FOR *DIMINISHING MUSHARAKA* IN REAL ESTATE

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For construction phase</strong></td>
<td>The property is entirely pre-leased through the tenor of the contract or pre-sold to an investment grade tenant or buyer.</td>
<td>The property is entirely pre-leased or pre-sold to a creditworthy tenant or investor.</td>
<td>Leasing activity is within projections but the building may not be pre-leased. The NFS may be the permanent investor.</td>
<td>The property is deteriorating due to cost overruns, market deterioration, tenant cancellations or other factors. There may be a dispute with the party providing the permanent financing.</td>
</tr>
<tr>
<td><strong>Asset characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Location</strong></td>
<td>Property is located in highly desirable location that is convenient to services that tenants desire.</td>
<td>Property is located in desirable location that is convenient to services that tenants desire.</td>
<td>The property location lacks a competitive advantage.</td>
<td>The property's location, configuration, design and maintenance have contributed to the property's difficulties.</td>
</tr>
<tr>
<td><strong>Design and condition</strong></td>
<td>Property is favoured due to its design, configuration, and maintenance, and is highly competitive with new properties.</td>
<td>Property is appropriate in terms of its design, configuration and maintenance. The property's design and capabilities are competitive with new properties.</td>
<td>Property is adequate in terms of its configuration, design and maintenance.</td>
<td>Weaknesses exist in the property's configuration, design or maintenance.</td>
</tr>
</tbody>
</table>
**SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING MUSHRABA KA IN REAL ESTATE**

<table>
<thead>
<tr>
<th>Property is under construction</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.</td>
<td>Construction budget is conservative and technical hazards are limited. Contractors are highly qualified.</td>
<td>Construction budget is adequate and Contractors are ordinarily qualified.</td>
<td>Business venture is over budget or unrealistic given its technical hazards. Contractors may be under qualified.</td>
<td></td>
</tr>
</tbody>
</table>

| Strength of Musharaka partner(s) | Financial capacity and willingness to support the property. | The partner has substantial resources and limited direct and contingent liabilities. | The partner's financial condition allows it to support the property in the event of a cash flow shortfall. | The partner is average to below average in financial resources. | The partner lacks capacity or willingness to support the property. |
## SUPERVISORY SLOTTING CRITERIA FOR DIMINISHING MUSHARAKA IN REAL ESTATE

<table>
<thead>
<tr>
<th></th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reputation and track record with similar properties</td>
<td>Experienced management and high partner's quality. Strong reputation and lengthy and successful record with similar properties</td>
<td>Appropriate management and partner's quality. The partner or management has a successful record with similar properties</td>
<td>Moderate management and sponsors' quality. Management or sponsor track record does not raise serious concerns</td>
<td>Ineffective management and substandard partners' quality. Management and partner difficulties have contributed to difficulties in managing properties in the past</td>
</tr>
<tr>
<td>Relationships with relevant real estate actors</td>
<td>Strong relationships with leading actors such as leasing agents</td>
<td>Proven relationships with leading actors such as leasing agents</td>
<td>Adequate relationships with leasing agents and other parties providing important real estate services</td>
<td>Poor relationships with leasing agents and/or other parties providing important real estate services</td>
</tr>
<tr>
<td>Divestment and Liquidation</td>
<td>Legally enforceable to sell / liquidate the property</td>
<td>Legally enforceable to sell / liquidate the property</td>
<td>Legally enforceable to sell / liquidate the property</td>
<td>Ability to sell / liquidate the property is constrained and time consuming</td>
</tr>
<tr>
<td>Legal infrastructure</td>
<td>Appropriate</td>
<td>Appropriate</td>
<td>Appropriate</td>
<td>Substandard</td>
</tr>
<tr>
<td>Quality of the Takaful or insurance coverage</td>
<td>Appropriate</td>
<td>Appropriate</td>
<td>Appropriate</td>
<td>Substandard</td>
</tr>
</tbody>
</table>
11.3 An Illustrative Outline of the ICAAP Document

1. What is an ICAAP document?

The ICAAP Document is a comprehensive paper furnishing detailed information on the ongoing assessment of the Licensee’s entire spectrum of risks, how the Licensee intends to mitigate those risks and how much current and future capital is necessary for the Licensee, reckoning other mitigating factors. The purpose of the ICAAP document is to apprise the Board of the Licensee on these aspects as also to explain to the Central Bank the Licensee’s internal capital adequacy assessment process and the Licensee’s approach to capital management.

The ICAAP could also be based on the existing internal documentation of the Licensee. The ICAAP document submitted to the Central Bank should be formally approved by the Licensee’s Board. It is expected that the document would be prepared in a format that would be easily understood at the senior levels of management and would contain all the relevant information necessary for the Licensee and the Central Bank to make an informed judgment as to the appropriate capital level of the Licensee and its risk management approach. Where appropriate, technical information on risk measurement methodologies, capital models, if any, used and all other work carried out to validate the approach (e.g. board papers and minutes, internal or external reviews) could be furnished to the Central Bank as appendices to the ICAAP Document.

2. Contents

The ICAAP Document should contain the following sections:

I. Executive Summary
II. Background
III. Summary of current and projected financial and capital positions
IV. Capital Adequacy
V. Firm-wide risk oversight and specific aspects of risk management
VI. Key sensitivities and future scenarios
VII. Aggregation and diversification
VIII. Testing and adoption of the ICAAP
IX. Use of the ICAAP within the Licensee

I. Executive Summary

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:

a) The purpose of the report and the regulated entities that are covered by the ICAAP;
b) The main findings of the ICAAP analysis:

i. How much and what composition of internal capital the Licensee considers it should hold as compared with the minimum CRAR requirement (CRAR) under ‘Pillar 1’ calculation, and
ii. The adequacy of the Licensee’s risk management processes;

c) A summary of the financial position of the Licensee, including the strategic position of the Licensee, its balance sheet strength, and future profitability;

d) Brief descriptions of the capital raising and dividend plan including how the Licensee intends to manage its capital in the days ahead and for what purposes;

e) Commentary on the most material risks to which the Licensee is exposed, why the level of risk is considered acceptable or, if it is not, what mitigating actions are planned;

f) Commentary on major issues where further analysis and decisions are required; and

g) Who has carried out the assessment, how it has been challenged / validated / stress tested, and who has approved it.

II. Background

This would cover the relevant organisational and historical financial data for the Licensee, e.g. organization structure (legal and operational), operating profit, profit before tax, profit after tax, dividends, shareholders funds, capital funds held vis-à-vis the regulatory requirements, customer deposits, deposits by banks, total assets, and any
conclusions that can be drawn from trends in the data which may have implications for the Licensee’s future.

### III. Summary of current and projected financial and capital positions

This would explain the present financial position of the Licensee and expected changes to the current business profile, the environment in which it expects to operate, its projected business plans (by appropriate lines of business), projected financial position, and future planned sources of capital. The starting balance sheet used as reference and date as of which the assessment is carried out should be indicated. The projected financial position could reckon both the projected capital available and projected capital requirements based on envisaged business plans. These might then provide a basis against which adverse scenarios might be compared.

### IV. Capital Adequacy

This might start with a description of the Licensee’s risk appetite, in quantitative terms, as approved by the Licensee’s Board and used in the ICAAP. It would be necessary to clearly spell out in the document whether what is being presented represents the Licensee’s view of the amount of capital required to meet minimum regulatory needs or whether represents the amount of capital that a bank believes it would need to meet its business plans. For instance, it should be clearly brought out whether the capital required is based on a particular credit rating desired by the Licensee or includes buffers for strategic purposes or seeks to minimise the chance of breaching regulatory requirements. Where economic capital models are used for internal capital assessment, the confidence level, time horizon, and description of the event to which the confidence level relates, should also be enumerated. Where scenario analyses or other means are used for capital assessment, then the basis / rationale for selecting the chosen severity of scenarios used, should also be included. It would then include a detailed review of the capital adequacy of the Licensee. The information provided would include the following elements:

#### Timing

- The effective date of the ICAAP calculations together with details of any events between this date and the date of submission to the Board / Central Bank which would
Islamic Banking Regulatory Framework

materially impact the ICAAP calculations together with their effects; and
• Details of, and rationale for, the time period selected for which capital requirement has been assessed.

**Risks Analysed**

• An identification of the major risks faced by the Licensee in each of the following categories:

  a) credit risk
  b) market risk
  c) operational risk
  d) liquidity risk
  e) concentration risk
  f) strategic risk
  g) business risk
  h) reputational risk
  i) other residual risk

• For each of these risks, an explanation of how the risk has been assessed and to the extent possible, the quantitative results of that assessment;
• Where some of these risks have been highlighted in the report of the Central Bank’s on-site examination of the Licensee, an explanation of how the Licensee has mitigated these;
• Where relevant, a comparison of the Central Bank-assessed CRAR during on-site examination with the results of the CRAR calculations of the Licensee under the ICAAP;
• A clear articulation of the Licensee’s risk appetite, in quantitative terms, by risk category and the extent of its consistency (its ‘fit’) with the overall assessment of bank’s various risks; and
• Where relevant, an explanation of any other methods, apart from capital, used by the Licensee to mitigate the risks.
Methodology and Assumptions

A description of how assessments for each of the major risks have been approached and the main assumptions made. For instance, banks may choose to base their ICAAP on the results of the CRAR calculation with the capital for additional risks (e.g. concentration risk, etc.) assessed separately and added to the Pillar 1 computations. Alternatively, banks could choose to base their ICAAP on internal models for all risks (approved by Central Bank where necessary), including those covered under the CRAR (i.e. Credit, Market and Operational Risks). The description here would make clear which risks are covered by which modeling or calculation approach. This would include details of the methodology and process used to calculate risks in each of the categories identified and reason for choosing the method used in each case. Where the Licensee uses an internal model for the quantification of its risks, this should explain for each of those models:

- The key assumptions and parameters within the capital modeling work and background information on the derivation of any key assumptions;
- How parameters have been chosen, including the historical period used and the calibration process;
- The limitations of the model;
- The sensitivity of the model to changes in those key assumptions or parameters chosen; and
- The validation work undertaken to ensure the continuing adequacy of the model.

Where stress tests or scenario analyses have been used to validate, supplement or probe the results of other modeling approaches, then this should provide:

- Details of simulations to capture risks not well estimated by the Licensee’s internal capital model (e.g. non-linear products, concentrations, illiquidity and shifts in correlations in a crisis period);
- Details of the quantitative results of stress tests and scenario analyses the Licensee carried out and the confidence levels and key assumptions behind those analyses, including, the distribution of outcomes obtained for the main individual risk factors;
- Details of the range of combined adverse scenarios which have been applied, how these were derived and the resulting capital requirements; and
- Where applicable, details of any additional business-unit-specific or business plan-
specific stress tests selected.

**Capital Transferability**

In case of banks with group/conglomerate/multinational structure, details of any restrictions on the management’s ability to transfer capital into or out of the Islamic Banking business(es) including to overseas branches, arising from, for example, by contractual, commercial, regulatory or statutory constraints that apply, should be furnished. Any restrictions applicable and flexibilities available for distribution of dividend by the entities in the Group could also be enumerated. In case of overseas banking subsidiaries of the Licensees, the regulatory restrictions would include the minimum regulatory capital level acceptable to the host-country regulator of the subsidiary, after declaration of dividend.

**V. Firm-wide risk oversight and specific aspects of risk management**

**V.1 Risk Management System at the Licensee**

This would describe the risk management infrastructure within the Licensee along the following lines:

- The oversight of board and senior management
- Overall policy approach of the Licensee to convey risk appetite/ tolerance, Procedures and Limits
- Identification, measurement, mitigation, controlling and reporting of risks
- MIS at the firm wide level
- Internal controls

**V.2 Off-balance Sheet Exposures**

This would comprehensively discuss and analyse underlying risks inherent in the off-balance sheet exposures particularly its investment in structured products. Bank should thoroughly analyse the credit quality and risk characteristics of the underlying exposures. This should also comprehensively explain the maturity of the exposures relative to issued liabilities in order to assess potential maturity mismatches.
V.3 Assessment of Reputational Risk and Implicit Support

This should discuss the possibilities of reputational risk leading to provision of implicit support, which might give rise to credit, market and legal risks. This should thoroughly discuss potential sources of reputational risk to the Licensee.

V. 4 Assessment of Valuation and Liquidity Risk

This would describe the governance structures and control processes for valuing exposures for risk management and financial reporting purposes, with a special focus on valuation of illiquid positions. This will have relevant details leading to establishment and verification of valuations for instruments and transactions in which it engages.

V. 5 Stress Testing practices

This would explain the role of board and senior management in setting stress testing objectives, defining scenarios, discussing the results of stress tests, assessing potential actions and decision making on the basis of results of stress tests. This would also describe the rigorous and forward looking stress testing that identifies possible events or changes in market conditions that could adversely affect the Licensee. Central Bank would assess the effectiveness of banks’ stress testing program in identifying relevant vulnerabilities.

V. 6 Sound Compensation practices

This should describe the compensation practices followed by the Licensee and how far the compensation practices are linked to long-term capital preservation and the financial strength of the firm. The calculation of risk-adjusted performance measure for the employees and its link, if any, with the compensation should clearly be disclosed.

VI. Key sensitivities and future scenarios

This would explain how the Licensee would be affected by an economic recession or downswings in the business cycle or markets relevant to its activities. The Central Bank would like to be apprised as to how the Licensee would manage its business and capital
so as to survive recession while meeting the minimum regulatory standards. The analysis would include future financial projections for, say, three to five years based on business plans and solvency calculations. For the purpose of this analysis, the severity of the recession reckoned should typically be one that occurs only once in a 25 year period. The time horizon would be from the day of the ICAAP calculation to at least the deepest part of the recession envisaged. The Licensees may evolve their horizon of stress tests and apprise the Central Bank. ICAAP should perform stress tests by defining three scenarios: High, Medium and Low Risk, with appropriate level of shock.

Typical scenarios would include:

• How an economic downturn would affect:
  o The Licensee’s capital funds and future earnings; and
  o The Licensee’s CRAR taking into account future changes in its projected Balance sheet.

• In both cases, it would be helpful if these projections show separately the effects of management actions to change the Licensee’s business strategy and the implementation of contingency plans.

• Projections of the future CRAR would include the effect of changes in the credit quality of the Licensee’s credit risk counterparties (including migration in their ratings during a recession) and the Licensee’s capital and its credit risk capital requirement;

• An assessment by the Licensee of any other capital planning actions to enable it to continue to meet its regulatory capital requirements throughout a recession such as new capital injections from related companies or new share issues;

• This would also explain which key macroeconomic factors are being stressed, and how those have been identified as drivers of the Licensee’s earnings. The Licensee would also explain how the macroeconomic factors affect the key parameters of the internal model by demonstrating, for instance, how the relationship between the two has been established.

Management Actions

This would elaborate on the management actions assumed in deriving the ICAAP, in particular:

• The quantitative impact of management actions – sensitivity testing of key
management actions and revised ICAAP figures with management actions excluded.

• Evidence of management actions implemented in the past during similar periods of economic stress.

VII. Aggregation and Diversification

This would describe how the results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. At a technical level, this would, therefore, require some method to be used to combine the various risks using some appropriate quantitative techniques. At the broader level, the overall reasonableness of the detailed quantification approaches might be compared with the results of an analysis of capital planning and a view taken by senior management as to the overall level of capital that is considered appropriate.

• In enumerating the process of technical aggregation, the following aspects could be covered:
  i) Any allowance made for diversification, including any assumed correlations within risks and between risks and how such correlations have been assessed, including in stressed conditions;
  ii) The justification for any credit taken for diversification benefits between legal entities, and the justification for the free movement of capital, if any assumed, between them in times of financial stress;
  iii) The impact of diversification benefits with management actions excluded. It might be helpful to work out revised ICAAP figures with all correlations set to ‘1’ i.e., no diversification; and similar figures with all correlations set to ‘0’ i.e. assuming all risks are independent i.e., full diversification.

• As regards the overall assessment, this should describe how the Licensee has arrived at its overall assessment of the capital it needs taking into account such matters as:
  i) The inherent uncertainty in any modeling approach;
  ii) Weaknesses in the Licensee’s risk management procedures, systems or controls;
  iii) The differences between regulatory capital and internal capital; and
  iv) The differing purposes that capital serves; shareholder returns, rating objectives for the Licensee as a whole or for certain debt instruments the Licensee has issued, avoidance of regulatory intervention, protection against uncertain events,
depositor protection, working capital, capital held for strategic acquisitions, etc.

VIII. Testing and Adoption of the ICAAP

This would describe the extent of challenging and testing that the ICAAP has been subjected to. It would thus include the testing and control processes applied to the ICAAP models and calculations. It should also describe the process of review of the test results by the senior management or the Board and the approval of the results by them. A copy of any relevant report placed before the senior management or the Board of the Licensee in this regard, along with their response, could be attached to the ICAAP Document sent to the Central Bank. Details of the reliance placed on any external service providers or consultants in the testing process, for instance, for generating economic scenarios, could also be detailed here. In addition, a copy of any report obtained from an external reviewer or internal audit should also be sent to the Central Bank.

IX. Use of the ICAAP within the Licensee

This would contain information to demonstrate the extent to which the concept of capital management is embedded within the Licensee, including the extent and use of capital modeling or scenario analyses and stress testing within the Licensee’s capital management policy. For instance, use of ICAAP in setting pricing and charges and the level and nature of future business, could be an indicator in this regard.

This could also include a statement of the Licensee’s actual operating philosophy on capital management and how this fits into the ICAAP Document submitted. For instance, differences in risk appetite used in preparing the ICAAP Document vis-à-vis that used for business decisions might be discussed. It may also include use test for effective and appropriate use of other risk management tools/assessment results by the Licensee as a whole.

Lastly, the Licensees may also furnish the details of any anticipated future refinements envisaged in the ICAAP (highlighting those aspects which are work-in-progress) apart from any other information that the Licensee believes would be helpful to the Central Bank in reviewing the ICAAP Document.
11.4 **Definitions**

11.4.1 **Capital Adequacy:** A measure of the financial strength of a Licensee, usually expressed as a percentage ratio of its capital to its assets.

11.4.2 **Profit-Sharing Investment Account:** Profit-Sharing Investment Account refers to a pool of investment funds placed with a Licensee, usually in a Mudaraba contract, where investment accounts are managed by the Licensee for an agreed profit-sharing percentage.

11.4.3 **Displaced Commercial Risk:** Displaced commercial risk refers to the phenomenon peculiar to Islamic Banks / Windows whereby some business risk is transferred to shareholders in order to cushion the IAH from bearing some or all of the risks to which they are contractually exposed in Mudaraba funding contracts.

11.4.4 **Hamish Jiddiyah:** Hamish Jiddiyah is a security deposit held as collateral upon entering into an agreement to purchase or an agreement to lease.

11.4.5 **Murabaha to the Purchase Orderer:** Murabaha to the Purchase Orderer or MPO contract refers to an agreement whereby the Licensee sells to a customer at cost plus an agreed profit margin a specified kind of asset that has been purchased and acquired by the Licensee based on a Promise to Purchase by the customer.

11.4.6 **Parallel Salam:** Parallel Salam is a back-to-back contract to sell a commodity with the same specification as the purchased commodity under a Salam contract to a party other than the original seller.

11.4.7 **Parallel Istisna’a:** Parallel Istisna’a is a back-to-back contract where the services of a party other than the Istisna’a ultimate buyer can be engaged to act in the capacity of a supplier or subcontractor.

11.4.8 **Ijarah Muntahia Bittamleek:** Ijarah Muntahia Bittamleek is the contract in which the lessor (“Licensee”) promises to transfer its ownership of the leased asset to the lessee at the end of the contract as a gift or as a sale at a specified consideration, provided that (a) the promise is separately expressed and independent of the underlying Ijarah; or (b) a gift contract is entered into conditional upon fulfilment of all the Ijarah obligations, and thereby ownership should be automatically transferred thereupon.
11.4.9 **Diminishing Musharaka**: Diminishing Musharaka is a form of Musharaka with the objective of transferring the ownership to the partner/customer, where the Licensee acts as a joint-owner of the asset with a promise by the partner to purchase the Licensee’s share over a period of time, making a payment on one or more specified future dates.

11.4.10 **Salam Sukuk**: Salam Sukuk represents fractional ownership of the capital of a Salam transaction, where the Salam capital is constituted by an advance payment to counterparty as supplier of a commodity (the subject-matter) to be delivered at a future date.

11.4.11 **Istisna’a Sukuk**: Istisna’a Sukuk represents a fractional share in the project financing of an undertaking to manufacture or construct an asset for a customer at a price to be paid in future instalments, the total of which equals the total face value of the Sukuk, in addition to mark-up.

11.4.12 **Ijarah Sukuk**: Ijarah Sukuk represents the holder’s proportionate ownership in a leased asset where the Sukuk holders collectively assume the rights and obligations of the lessor.

11.4.13 **Musharaka Sukuk**: Musharaka Sukuk represents the direct pro-rata ownership of the holder in the assets of a private commercial enterprise or a project where the subscription money is normally employed in purchasing non-liquid assets such as real estate or moveable assets.

11.4.14 **Mudaraba Sukuk**: Mudaraba (Muqarada) Sukuk are certificates issued by a Mudarib and share the profit and bear any losses arising from the Mudaraba operations.

11.4.15 **Urbun**: Urbun is the earnest money held after a contract is established as collateral to guarantee contract performance.

11.4.16 **Rate of Return Risk**: Rate of return risk refers to the possible impact on the net income of the Licensee arising from the impact of changes in the market rates and relevant benchmark rates on the return on assets and on the returns payable on funding.

11.4.17 **Qard**: Loans fixed for a definite period of time without interest or profit sharing.
11.4.18 **Kafalah:** Surety for paying the price or sum if unpaid by the person originally liable.

11.4.19 **Rahn:** Pledge or mortgage.

11.4.20 **Wakala:** Agency.

11.4.21 **Sadaqah:** Anything given away in charity in the name of Allah.

11.4.22 **Zakah:** Compulsory levy on every Muslim who has wealth greater than a minimum amount (called Nisab). The amount payable by a Muslim on his/her net worth as a part of his/her religious obligations, mainly for the benefit of the poor and the needy.
TITLE 6: CREDIT RISK

Islamic Banking Regulatory Framework
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1. Building Blocks of Credit Risk Management

1.1 Introduction

1.1.1 Licensees face many risks. Credit risk is defined as the possibility that counterparty fails to meet its obligations in accordance with agreed terms in relation to financing, trading, hedging, settlement or other financial transactions.

1.1.2 Credit risk exists throughout Licensees’ activities, both on and off balance sheet, and arises from the Licensees’ dealings with or financing to corporate, individuals, other Licensees, financial institutions etc., resident or non-resident. Licensees need to manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration. Credit risk also includes the risk arising in the settlement and clearing transactions.

1.1.3 Credit risk also manifests from the financing of receivables and leases (for example, Murabaha, Diminishing Musharaka and Ijarah) and financing of working capital (for example, Salam or Istisna’a). Licensees may embrace the role of financiers, suppliers, Rabb-ul-Mal and contributor of capital in Musharaka agreement. Licensees concern themselves with the risk of counterparty’s failure to meet their obligations in terms of receiving deferred payment and making or taking delivery of an asset.

1.1.4 Credit risk management enables Licensees to identify, assess, manage proactively, minimise and mitigate their credit risk at an individual or entity or country level. Given the dynamic environment, it is important that Licensees have robust credit risk management policies and procedures, which should be sensitive and responsive to changes in their operating environment.

1.1.5 These rules and guidelines address the credit risk associated with specific features of Islamic financing contracts. The credit risk principles in this section are also applicable to credit risks associated with financing made under the profit sharing modes (e.g. Mudaraba and Musharaka). The Licensees should however be mindful that this set of rules and guidelines is not exhaustive and the Licensees would need to be adaptive according to their special characteristics.

1.2 Strategy for Credit Risk Management

1.2.1 Licensees shall define and set the institution’s overall levels of risk appetite, risk diversification and asset allocation strategies applicable to each mode of financing, economic activity, geographical spread, currency and tenor. It is essential that each Licensee develops its own credit risk management
strategy or credit-granting function. This will necessarily translate into identification of target markets and business sectors, preferred levels of diversification and concentration, the cost of capital in granting credit and bad debts.

1.2.2 When setting the level of risk appetite relating to counterparties, Licensees shall ensure that (a) the expected rate of return on a transaction is commensurate with the risks incurred; and (b) excessive credit risk (at both individual and portfolio levels) and risk concentration (for example mode of financing, economic activity, geographical spread) are being managed effectively.

1.2.3 Licensees’ financing strategies shall include a list of all types of applicable and approved transactions and financings. The approved list must include formal exclusions from any engagement by the Licensees in industries dealing in Haram or unlawful goods and services. The approved list shall be kept up to date and communicated to the relevant personnel within the Licensees, and Internal Shari’a Review function shall be organized and empowered to ensure that such rules are applied.

1.2.4 The credit risk strategy shall also take into account the cyclical aspects and the resulting shifts in the composition and quality of the asset portfolio. This strategy shall be viable in the long run and across business cycles.

1.2.5 Investment Account Holders (“IAHs”) share the risks in the assets financed through the Profit Sharing Investment Accounts (“PSIA”). This allows the Licensees to reduce the inherent risks and recognise PSIAs as risk absorbents of part of the credit risk faced by the Licensees.

1.3 Credit Policies & Procedures

1.3.1 A properly documented credit policy is an essential element of and prerequisite for the credit risk management process. Consistent with the Board’s objectives, it assists Licensee management in the maintenance of proper credit standards and the avoidance of unacceptable risks.

1.3.2 Licensees shall review the credit policy regularly to ensure that once it is established, it remains flexible enough to be current and continues to accomplish its original purpose taking into consideration market developments.

1.3.3 The policy document shall cover issues such as organizational responsibilities, risk measurement techniques, prudential requirements /
limits, portfolio management techniques, risk assessment and reviews, reporting, risk grading, product guidelines, documentation, legal issues and management of problem credits.

1.3.4 Keeping in view the foregoing, an Licensee shall have the following in place:

1.3.4.1 Dedicated policies and procedures to control exposures to higher risk sectors such as capital market, real estate, personal financing, trading, etc.

1.3.4.2 Sound procedures to ensure that all risks associated with credit facilities are promptly and comprehensively evaluated.

1.3.4.3 System to assign risk ratings to all categories of counterparties.

1.3.4.4 A mechanism to price facilities depending on the risk grading, and to attribute accurately the associated risk weightings to the facilities.

1.3.4.5 Efficient and effective credit approval process operating within the limits authorized by the Board of Directors.

1.3.4.6 Procedures and systems that allow for monitoring financial performance of counterparties and for controlling exposures within limits.

1.3.4.7 Systems to manage problem financing transactions to ensure appropriate processes and efforts for recovery.

1.3.4.8 A process to conduct regular analysis of the portfolio and to ensure ongoing control of risk concentrations.

1.3.5 The credit policies and procedures shall necessarily have the following elements:

1.3.5.1 Written policies that define target markets, risk acceptance criteria, credit approval authority, credit origination and maintenance procedures and guidelines for portfolio management and remedial management.

1.3.5.2 Licensees shall have a policy for carrying out a due diligence process in evaluating counterparties, in particular, for transactions involving new ventures with multiple financing modes.

1.3.5.3 Licensees must be aware of exposure to credit risk inherent in different modes of financing. Licensees shall assess credit risk for each financing instrument and have appropriate internal controls and risk management systems to mitigate risks with each instrument.

1.3.5.4 Licensees shall have a policy in place to first recognize overlapping and interconnected nature of risks and to mitigate such risks.
1.3.5.5 Licensees must have in place Shari’a-compliant credit risk mitigating techniques appropriate for each mode of Islamic financing.

1.3.5.6 Licensees shall consider the complete lifecycle of the Shari’a compliant financial instrument and have appropriate policies to put in place in place internal controls and risk management system to mitigate credit risk, whenever it arises.

1.3.5.7 Licensees shall have in place a strategy for financing, using various instruments in compliance with Shari’a, whereby they recognize the potential credit exposures that may arise at different stages of the various financing agreements.

1.3.5.8 Every extension of credit, barring small value retail / personal financing transaction must be approved by at least two authorized credit officers.

1.3.5.9 Benchmark financial ratios and other qualitative factors shall be defined in the policy, with flexibility for deviations in deserving cases. The conditions subject to which deviations are permitted and the authority should be clearly spelt out in the Credit Policy.

1.3.5.10 Every obligor and facility must be assigned a risk rating.

1.3.5.11 Licensees shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument. The methodology should be appropriate given the nature, size and complexity of the Licensees’ credit related activities. Licensees shall ensure that adequate systems and resources are available to implement this methodology.

1.3.5.12 Licensees shall establish appropriate policies and procedures that require them to honor their commitment to the parallel contract counterparty. The two contracts – that of the transaction and the parallel transaction – shall be independent and Licensees shall not link the two contracts legally to transfer the risk with the Licensee to the counterparty.

1.3.5.13 Licensees should assess the risks associated with their own exposures in parallel transactions and should establish appropriate policies and procedures mitigating these risks.

1.3.5.14 For example, Licensees may decide to have formal policies that limit their open positions.
1.3.5.15 The financing transactions’ approval powers shall be granted to individual credit officers based upon a consistent set of standards of experience, judgment and ability.

1.3.5.16 The level of authority required for approving credit limits shall increase as amounts and transaction risks increase and as risk ratings worsen.

1.3.5.17 Licensees shall ensure that there are consistent standards for the origination, documentation and maintenance for extensions of credit.

1.3.5.18 Proactive credit risk management practices like annual / half yearly industry studies and single obligor reviews, periodic credit calls and field visits shall be documented and at least quarterly management reviews of troubled exposures / weak credits shall be carried out.

1.3.5.19 Licensees shall conduct periodic reviews and field visits of the collateral support, which shall also be documented.

1.3.5.20 Licensees shall have a consistent approach towards early problem recognition, the classification of problem exposures and remedial action.

1.3.5.21 Business managers in Licensees are accountable for managing risk and in conjunction with credit risk management framework for establishing and maintaining appropriate risk limits and risk management procedures.

1.3.5.22 Licensees shall maintain a diversified portfolio of assets in line with the capital desired to support such a portfolio.

1.3.5.23 Credit risk limits shall include, but are not limited to, obligor limits and concentration limits by industry or geography. Licensees are encouraged to adopt prudent self-imposed limitations and not restrict themselves to the prudential limits.

1.3.5.24 Licensees shall accurately, completely and in a timely fashion report the comprehensive set of credit risk data into the independent risk system to ensure transparency of risks taken.

1.3.6 Licensees should also evolve suitable framework for reporting and evaluating the quality of credit decisions taken by various functional groups. The quality of credit decisions should be evaluated within a reasonable time, say 3-6 months, through a well-defined Credit Review Mechanism. Licensees should ensure that the output of the review is factored in future policies and practices.

1.3.7 Policy should cover conditions, limitations and authority for exceptions to policy parameters.
1.4 Organizational Structure

1.4.1 Role of the Board of Directors

1.4.1.1 The Board of Directors must approve all the policies of a Licensee. Given that credit risk is still the major risk that Licensees are exposed to in their business, particular attention must be paid to credit policies, in terms of various limits as well as in terms of risk strategy. The Board shall also regularly review overdue and large facilities both in terms of performance, and also in relation to the capital (base) of the Licensee. The Board shall insist upon periodic review / evaluation of internal systems and control weaknesses identified by external / internal auditors and management.

1.4.2 Role of the senior management

1.4.2.1 Senior management shall be responsible for implementation and compliance of Board accepted policies and directives.

1.4.2.2 Senior management shall be involved in regular reviews of outstanding facilities and overdue accounts as well as reviews of changes in activity, turnover or balances in counterparties’ accounts.

1.4.2.3 Senior management shall take greater responsibility of customer due diligence and other aspects in high risk accounts as compared to other accounts.

1.4.2.4 Senior management shall be involved in the credit review process of (larger) existing facilities, visiting clients, requesting up to date financial statements and verifying collateral.

1.4.2.5 Each Islamic Bank may, depending on the size of the organization or asset book, constitute a high level Credit Policy Committee (CPC) also called Credit Risk Management Committee or Credit Control Committee, etc. to deal with issues relating to credit policy and procedures and to analyse, manage and control credit risk on an organization wide basis. The Committee could be headed by the Chief Executive Officer (CEO) and should comprise heads of Credit Department including Consumer Banking, Treasury, Credit Risk Management Department (CRMD) and the Chief Economist (if the Licensee has one).

1.4.2.6 The Committee shall, inter alia, formulate clear policies on standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, standards for collateral, portfolio management, credit review mechanism, risk concentrations, risk
monitoring and evaluation, pricing of financing facilities, provisioning, regulatory / legal compliance, etc. Such policies should be presented to the Board for their approval.

1.4.3  Role of an Independent Risk Management Function

1.4.3.1  Credit risk management shall be vested with an independent group to ensure effective functioning of the risk management framework. This ensures that decisions are made with sufficient emphasis on asset quality. Concurrently, each Licensee shall set up a CRMD.

1.4.3.2  CRMD shall formulate credit policies, risk limits and procedures and exert controls to all of its credit risk arising from corporate banking, treasury, credit cards, personal banking, trade finance, securities processing, payment and settlement systems, etc. Such policies should be presented to the Board for their approval.

1.4.3.3  The CRMD should also enforce and monitor compliance of the risk parameters and prudential limits set by the CPC. The CRMD should also lay down risk assessment systems, monitor quality of asset portfolio, identify problems and correct deficiencies, develop MIS and undertake credit review / audit.

1.4.4  Effective Internal Systems and Controls

1.4.4.1  Well implemented sound policies and procedures maintain credit standards, enable monitoring and control of credit risk, and identify problem credits in a timely manner.

1.4.4.2  Policies and procedures should allow a thorough understanding of the counterparty, the purpose of the credit facility and the source of repayment to be gained by the Risk Management function in its assessment of the counterparty for risk profiling purposes.

1.4.4.3  The credit risk strategy and policies shall be effectively communicated throughout the organisation. All credit officers should clearly understand the Licensee’s approach to financing and should be held accountable for complying with the policies, risk limits and procedures.
1.4.4.4 Licensees shall utilise internal rating systems to manage credit risk and to set adequate provisions on a timely basis.

1.4.4.5 The independence of the credit risk management team shall be preserved. The Board shall ensure that this is not allowed to be compromised at any time.

1.4.4.6 Licensees should ensure that the functions of all committees, bodies and other authorities are defined avoiding the conflicts of roles and interests. For instance, the Board’s power of approval of policies should not be used by any other body or any other control function (e.g. risk management should not be involved in approvals).

1.4.5 The Role of Internal Audit

1.4.5.1 Internal audit function must, on an on-going basis, monitor the system of internal controls in credit processes because it provides an independent assessment of the adequacy of, and compliance with, the established policies and procedures.

1.4.5.2 Internal audit function should report directly to the highest levels of the Licensee, typically the Board of Directors or its Audit Committee. This allows for the proper functioning of corporate governance by giving the Board information that is not biased in any way by the levels of management that the reports cover.

1.5 Credit Approving Authority

1.5.1 Each Licensee shall evolve a carefully crafted scheme of delegation of powers. The Licensees could endeavour to evolve a multi-tier credit approving system where the credit proposals are approved by an ‘Approval Grid’ or a ‘Committee’. The credit facilities above a specified threshold limit could be approved by the ‘Grid’ or ‘Committee’, comprising at least 3 or 4 officers and invariably one officer should represent the CRMD, who has no business or profit targets. Licensees can ensure that the views and concerns of the independent credit risk management function are duly taken into account through this mechanism.

1.5.2 Licensees can also consider credit approving committees at various operating levels i.e. large branches (where considered necessary), control points, etc. Licensees may also consider delegating powers for sanction of higher limits to the ‘Grid’ or ‘Committee’ for better rated / quality counterparties. The spirit of the credit approving system may be that no credit proposals could be approved or
recommended to higher authorities, if all the members of the ‘Grid’ or ‘Committee’ do not agree on the creditworthiness of the counterparties. Where the system permits approval of credit proposals by majority agreement, the specific views of the dissenting member/s should be recorded and preserved for review / audit.

1.5.3

There may be provision, as a good internal control mechanism, for approving authority to report its approvals for higher authority along with material details and exceptions if any with authority for relaxation.
2. **Credit Risk Management**

2.1 **Assessment of Credit Quality**

2.1.1 *Proper credit risk management helps Licensees to discipline their financing activities and ensure that credit facilities are granted on a sound basis, and that Licensee funds are invested in a profitable manner. The process of managing credit risk starts at the origination of the credit facility.*

2.1.2 Licensees shall have a policy for carrying out a due diligence process in evaluating counterparties, in particular, for transactions involving new ventures with multiple financing modes.

2.1.3 Standards for credit analysis should stress the counterparty’s ability to meet his future financial needs through analysis of his cash-flow generation capacity. Licensees shall obtain sufficient information to permit a comprehensive assessment of the risk profile of the counterparty prior to the financing being granted and on an ongoing basis.

2.1.4 Where significant investment risks are present in participatory instruments, especially in the case of Mudaraba or Musharaka financing, additional counterparty reviews and evaluations shall focus on the business purpose, operational capability, enforcement and economic substance of the proposed project including the assessment of realistic forecasts of estimated future cash flows.

2.1.5 Licensees, in their policy for approval, shall engage appropriate experts, including Internal Shari’a Reviewer to review and ensure that new financing proposals or amendments to existing contracts are Shari’a-compliant at all times.

2.1.6 Licensees should also engage an appropriate technical expert (for example an engineer) to evaluate the feasibility of a proposed new project and to assess and approve progress billings to be made under the contract.

2.1.7 In a financing involving several related agreements, Licensees shall be aware of the binding obligations arising in connection with credit risks associated with the underlying assets for each agreement. To be Shari’a compliant, subject to the interpretation of their Shari’a boards, Licensees shall ensure that all components of the financial structure are contractually independent, although these may be executed in a parallel manner.
2.1.8 Licensees shall be mindful of and take into account the permissible types of financing instruments available in different locations wherever Licensees undertake cross-border transactions.

2.2 Risk Mitigation

2.2.1 Risk mitigating structures shall be put in place by Licensees as far as possible. Licensees shall properly assess the inherent risk factors of each credit facility, monitor the risks arising from any portfolio concentration and ensure that appropriate precautions against losses have been taken.

2.2.2 Licensees should clearly define their credit risk-mitigating techniques for every financing transaction. The techniques may include, but are not limited to, having in place permissible and enforceable collateral and guarantees, clear documentation as to whether or not purchase orders are cancellable and clear procedures for taking account of governing laws for contracts relating to financing transactions.

2.2.3 Licensees may set appropriate measures for early settlements, which are permissible under Shari’a rules and principles for each mode of Islamic financing subject to approval of SSB.

2.3 Collateral

2.3.1 Licensee finance is often supported by collateral provided by the customer or third parties. Licensees shall within the credit policy clearly document the list of assets that may be accepted by them as collateral.

2.3.2 Licensees shall never base credit decisions only on the value of the collateral and should accept collaterals on otherwise appropriate financing facility for additional comfort.

2.3.3 In all cases, independent timely appraisals of the collateral shall be obligatory, including provision for sufficient security margins.

2.3.4 Licensees accepting property as collateral shall ensure that the appraisals for property are duly conducted every 3 years.

2.3.5 Licensees shall also ensure that all limitations of law in possessing and reselling of collaterals are considered while accepting collaterals.

2.3.6 In principle, collateral can improve the credit grading of a customer, but experience suggests that over-reliance on collateral is unsound because very often
when a credit facility goes sour the collateral turns out to have less value than estimated.

2.3.7 Collateral is often illiquid, difficult to value during periods of financial distress and costly to realise through foreclosure or other legal means. Particular concern may be appropriate in the case of collaterals in the form of real estate and shares, as they involve additional uncertainties, costs of maintaining the property etc.

2.3.8 As a matter of principle, collateral shall not replace a careful assessment of the counterparty’s ability to repay as the successful repayment of the counterparty’s obligations is primarily derived from the cash flows from the financed activity.

2.3.9 Licensee shall note that in commercial guarantee of personal financing, the guarantor may request the creditor to dispossess the debtor first before seeking recourse to the guarantor.

2.4 **Know Your Customer**

2.4.1 Effective Know Your Customer (“KYC”) procedures shall embrace requirement for proper management oversight, systems and controls, segregation of duties, training and other related policies.

2.4.2 The board of directors of the Licensee shall be fully committed to an effective KYC programme by establishing appropriate procedures and ensuring their effectiveness.

2.4.3 Explicit responsibility shall be allocated within the Licensee for ensuring that the Licensee's policies and procedures are managed effectively. The channels for reporting suspicious transactions shall be clearly specified in writing, and communicated to all personnel.

2.4.4 There shall also be internal procedures for assessing whether the Licensee’s statutory obligations under recognized suspicious activity reporting regimes require the transaction to be reported to the appropriate law enforcement and / or supervisory authorities, in addition to preventing unwarranted financial, reputational and other risks for the Licensee.

2.4.5 Licensees' internal audit and compliance functions have important responsibilities in evaluating and ensuring adherence to KYC policies and procedures. As a general rule, the compliance function should provide an independent evaluation of the Licensee’s own policies and procedures, including legal and regulatory requirements. Its responsibilities should include ongoing monitoring of staff
performance through sample testing of compliance and review of exception reports to alert senior management or the Board of Directors if it believes management is failing to address KYC procedures in a responsible manner.

2.4.6 Internal audit plays an important role in independently evaluating risk management and controls, discharging its responsibility to the Audit Committee of the Board of Directors or a similar oversight body through periodic evaluations of the effectiveness of compliance with KYC policies and procedures, including related staff training. The Audit Committee of the Board should ensure that audit functions are staffed adequately with individuals who are well-versed in such policies and procedures. In addition, internal auditors should be proactive in following up their findings and criticism.

2.4.7 All Licensees must have an ongoing employee training programme so that Licensee staff is adequately trained in KYC procedures. The timing and content of training for various levels of staff should be adapted by the Licensee for its own needs.

2.4.8 Training requirements should have a different focus for new staff, front-line staff, compliance staff and staff dealing with new customers. New staff should be educated in the importance of KYC policies and the basic requirements at the Licensee. Front-line staff members who deal directly with the public should be trained to verify the identity of new customers, to exercise due diligence in handling accounts of existing customers on an ongoing basis and to detect patterns of suspicious activity. Regular refresher training should be provided to ensure that staff are reminded of their responsibilities and are kept informed of new developments. It is crucial that all relevant staff fully understand the need for and implement KYC policies consistently. A culture within Licensees that promotes such understanding is the key to successful implementation.

2.4.9 External auditors also have an important role to play in monitoring Licensees’ internal controls and procedures, and in confirming that they are in compliance with supervisory practice.

2.5 Bank Credit & Statistical Bureau

2.5.1 Classified credit at any Licensee has potential to spread the disease in the system through the counterparties availing of multiple banking facilities. Information base of financing banks is enhanced by making available to them classified credit status of bank counterparties enjoying financing facilities with other Licensees. This
information base helps Licensees in achieving reduction in erosion of their assets in the form of reduced incidence of non-performing credits and advances.

2.5.2 **Bank Credit and Statistical Bureau System (“BCSB”) in the Central Bank is a database designed to collect, store and disseminate bank credit information to insulate Licensees from the risks associated with informational asymmetry, and to avoid instances of fraud and misrepresentation.**

2.5.3 The new BCSB system put in place by the Central Bank, using state-of-the-art technology, collects and collates both positive and negative information including the demographic data related to individuals and corporate entities, relationship and employment data, details of each credit/finance facility, collateral provided for each facility, etc. The Central Bank has issued new (Consumer and Corporate) Input File Formats (IFFs) in order for the Licensees to provide details of both performing and non-performing credit/finance. In addition to these data, the new system collects details of related cheque returns and litigation cases filed against those availing credit/finance.

2.5.4 Licensees are required to report the credit details, both funded and unfunded obligations, of all their customers to the System, in a manner determined by the Central Bank from time to time. The BCSB system is critically dependant on the quality of data provided by the banks to avoid adverse selection of counterparties by the Licensees. It is therefore the responsibility of the Licensees to ensure that the data provided is accurate, complete, and as per the required format with encryption and in File Transfer Protocol (FTP) via dedicated MPLS lines. Daily updating of the information is the most important feature of the new system as the Licensees are required to provide incremental updates daily.

2.5.5 The duty of timely and accurate reporting of data relating to bank credit rests with the Licensees and any breach thereof will be their responsibility, without any responsibility on the part of the Central Bank.

2.5.6 The data in the System should be used by the Licensees only for making credit decisions, monitoring the problem exposures of the customers including senior members in the management of Licensees, as per the rules laid down by the Central Bank. Information collected, collated and synthesized are provided back to the Licensees in the form of comprehensive Credit Information Reports (CIR) through web enabled credit information service which is an unlimited and 24 x 7 service.
2.5.7 BCSB system also provides for an automated Complaint Management System where the counterparties can get an Evidence Credit Information Report, which works as a counterparties discipline device and acts as an incentive for them to repay the credit/finance.

2.6 Risk Rating

2.6.1 A risk-rating framework is the basic module for developing a credit risk management system and even advanced credit risk models are based on this structure. The risk ratings would be relevant for individual credit selection, wherein a particular exposure / facility is linked to rating. The associated decisions on pricing (credit-spread or risk premium), setting apart general loss reserves and other specific features of Islamic banking transaction could also be related to risk rating. Further, the risk calibration could be used for surveillance and monitoring, internal MIS and assessing the aggregate risk profile. Thus, Licensees should develop a robust internal credit-risk grading system that serves as a single point indicator of diverse risk factors of counterparty, for taking credit decisions in a consistent manner and communicating the default risk associated with an exposure. The risk rating, in short, should reflect the underlying credit risk of the asset book.

2.6.2 The risk rating system shall be drawn up in a structured manner, incorporating both quantitative (financial ratios) and qualitative standards (industry, payment history, credit reports, management, purpose of the banking transaction, quality of financial information, financing transaction characteristics, etc). The Licensees may use any number of financial ratios and operational parameters as well as qualitative aspects of management and industry characteristics that have bearings on the underlying credit quality of counterparties. Licensees may also consider weighing various risk factors on the basis of period to which they represent for giving importance to near term developments. Within the rating framework, Licensees may consider prescribing certain level of standards or critical parameters, beyond which no proposals could be underwritten. There are significant differences across business lines or portfolios in the key risk factors and expected losses in Islamic transactions. Thus, the credit rating framework could be separate for relatively peculiar businesses like sovereigns, corporate, project finance, small businesses, retail, personal credits, banks, finance companies, real estate, etc on the basis of varying nature and degree of credit risk. Currencies exposures assumed by corporate
who have no natural hedges have significantly altered the risk profile of Licensees. Licensees may, therefore, factor the un-hedged market risk exposures of counterparties also into the rating framework.

2.6.3 Ratings should differentiate between good quality assets and exposures that show potential weaknesses. The rating should be forward looking and should capture any change in earning prospect of the counterparty in future.

2.6.4 Several banks utilize a numeric scale to reflect the risk ratings of their existing and proposed credit exposures. The number of grades for the “acceptable (performing)” and the “unacceptable (impaired)” credit risk categories would depend on the incremental effort and the related benefits of finer risk gradation. The overall score for risk is to be placed on a numerical scale ranging between 1-9, 1-12, etc. on the basis of credit quality.

2.6.5 The number of grades used in the rating framework should depend on the anticipated spread in credit-quality of the exposures, which is dependent on the present, and the future business profile, and the anticipated level of specialization / diversification in the credit portfolio.

2.6.6 Rating scale may contain 7 performing scales followed by special mention category and 3 non-performing scales. This will allow the Licensees to report their data to the Central Bank as per their original scales and would save them the additional effort of mapping their internal ratings to these 11 scales on an ongoing basis. This will also save the Licensees additional one time effort of developing the basis for mapping their internal rating scales to these 11 scales as required for the purpose of reporting to the Central Bank.

2.6.7 A Licensee can initiate the risk-grading activity on a relatively smaller / narrower scale and introduce new categories as risk-gradation improves and the spread of exposures widens. For each numerical category, a quantitative definition of the counterparty, the asset’s credit quality and an analytic representation of the underlying financials of the counterparty should be presented.

2.6.8 Further, as a prudent risk management policy, each Licensee should prescribe the minimum rating below which no exposures could be undertaken. Any flexibility in the minimum standards and conditions for relaxation and authority therefore should be clearly established in the Policy. In order to ensure consistency and accuracy of internal ratings, the responsibility for setting or confirming credit ratings should be vested with the CRMD or an independent Credit Review Group.

2.6.9 The ratings on various counterparties should be two-dimensional both on an obligor and a facility grade. The obligor rating mirrors the default probability of
the counterparty of its obligations, whereas the facility grade rating should be significantly different on the basis of collateral support, seniority and other structural aspects. The facility grade should be adjusted explicitly or implicitly by notching the grade higher or lower to reflect the attributes of the individual transactions. Further, the ratings on various counterparties should have a time horizon over which a particular rating is expected to be valid. Ideally, the ratings should cover the entire life of the facility.

2.6.10 However, a one-year horizon is mostly reckoned based on annual financial reporting cycles. The decision for longer periods impinges on relationship ties with the counterparty and the need to capture full range risk profile of the transaction. The rating system could also be tailor-made to distinguish on a point in time or through the cycle approach. The point in time rating reflects an assessment of the counterparty’s current conditions and / or most likely future conditions over the course of the chosen time horizon. Accordingly, the ratings undergo changes over the course of the credit / business cycles. On the other hand, the through the cycle rating requires assessment of the counterparty’s creditworthiness on a worst-case bottom of the cycle scenario. Under this case, the counterparties’ ratings tend to stay the same over the course of the credit / business cycles. While the Licensees could consider putting in place, initially, a point in time rating system, with due recognition of longer-term negative prospects, expertise may be developed to move over to through the cycle ratings over a period to capture the true risk profile of the counterparties, especially long-term exposures.

2.6.11 The quantum of credit to counterparty should be linked to the relative credit score. This would help in larger dispersion of risk amongst counterparties and limit concentrations.

2.6.12 The credit risk assessment exercise should be repeated biannually (or even at shorter intervals for low quality counterparties). The updating of the credit ratings should be undertaken normally at half-yearly intervals or at least yearly intervals, in order to gauge the quality of the portfolio at periodic intervals. The Licensee may try to synchronise the credit risk assessment exercise and updating of credit ratings in periodicity and time.

2.6.13 Variations in the ratings of counterparties over time indicate changes in credit quality and expected losses from the credit portfolio.

2.6.14 Licensees should undertake comprehensive study on migration (upward - lower to higher and downward - higher to lower) of counterparties in ratings to add accuracy in expected loss calculations.
2.6.15 The system should cover a broad range of the Licensee’s asset portfolio both on and off-balance sheet exposures.

2.7 Credit Risk Models

2.7.1 Many of the international banks have already adopted credit risk models for evaluation of credit portfolio. The credit risk models offer banks framework for quantifying, aggregating and managing risk across geographical and product lines in a timely manner. The outputs of these models also play increasingly important roles in banks’ risk management and performance measurement processes, including performance-based compensation, counterparty profitability analysis, risk-based pricing, active portfolio management and capital structure decisions. The models also provide estimates of credit risk (unexpected loss), which reflect individual portfolio composition. The models generally used by banks are:

2.7.1.1 The Altman’s Z score forecasts the probability of a company entering bankruptcy within a 12-month period. The model combines five financial ratios using reported accounting information and equity values to produce an objective measure of counterparty’s financial health. KMV Corporation has developed a credit risk model that uses information on stock prices and the capital structure of the firm to estimate its default probability. The starting point of this model is the proposition that a firm defaults only if its asset value falls below a certain level (default point), which is a function of its liability. It estimates the asset value of the firm and its assets’ volatility from the market value of equity and the debt structure in the option theoretical framework.

2.7.1.2 J. P. Morgan has developed a portfolio model Credit Metrics for evaluating credit risk. The model basically focuses on estimating the volatility in the value of assets caused by variations in the quality of assets. The volatility is computed by tracking the probability that the counterparty might migrate from one rating category to another (downgrade or upgrade). Thus, the value of assets can change over time, reflecting migration of the counterparties to a different risk-rating grade. The model can be used for promoting transparency in credit risk monitoring, establishing benchmark for credit risk measurement and estimating economic capital for credit risk under Risk Adjusted Return on Capital (“RAROC”) framework.

2.7.1.3 Credit Suisse developed a statistical method for measuring and accounting for credit risk, which is known as CreditRisk+. The model is based on actuarial calculation of expected default rates and unexpected losses from default.
2.7.2 The Licensees may evaluate the utility of these models with suitable modifications to the environment in the Sultanate for fine-tuning credit risk management. The success of credit risk models impinges on time series data on historical loss rates and other model variables, spanning multiple credit cycles. Licensees may, therefore, build adequate internal expertise and database for switching over to credit risk modelling after a specified period of time.

2.8 Portfolio Management

2.8.1 Licensees shall have appropriate credit management systems and administrative procedures in place to undertake early remedial action in the case of financial distress of counterparty or, in particular, for managing problem credits, potential and defaulting counterparties. This system shall be reviewed on a regular basis.

2.8.2 Remedial actions include both administrative and financial measures.

2.8.3 Administrative measures may, inter-alia, include:

2.8.3.1 negotiating and following up proactively through maintaining frequent contact with the counterparty;

2.8.3.2 setting an allowable timeframe for payment or to offer Shari’a compliant debt-rescheduling or restructuring arrangements;

2.8.3.3 resorting to legal action, including the attachment of any credit balance belonging to defaulters according to the agreement between them;

2.8.4 Financial measures may include, among others:

2.8.4.1 imposing penalties, the proceeds of which should be disposed of in charitable causes in compliance with Shari’a as decided by the Licensee’s Shari’a Supervisory Board (Licensees are prohibited from using the amount of any penalty for their own benefit; they must donate any such amount to charity.); and

2.8.4.2 Establishing the enforceability of collateral or third party guarantees.

2.8.5 Licensees shall establish limits on the degree of reliance and the enforceability of collateral and guarantees. They shall protect themselves against legal impediments that may restrict the accessibility of collateral when they need to enforce their rights in respect of a financing. Licensees shall also formally agree with the counterparty at the time of signing the contract on the usage, redemption and utilization of collateral if the counterparty defaults in payment. Licensee shall also review the Shari’a compliance of all such collaterals.
2.8.6 Licensees shall have policies to define adequately the action to be taken by them when a customer cancels a non-binding purchase order. The policies shall describe how the Licensees (a) monitor and control their exposures to suppliers, and especially during delivery between suppliers to the Licensees where a customer is acting as an agent; and (b) identify whether the risks associated with the assets are borne by the supplier or the Licensees (with or without the customer acting as an agent and accepting the assets from the supplier). For example, the Licensee may enter into a purchase contract with a supplier on a “sale or return” basis, with an option to return the purchased item within a specified period.

2.8.7 The need for credit portfolio management emanates from the potential adverse impact of concentration of exposures and necessity to optimize the benefits associated with diversification. The conventional approach to credit portfolio management has largely been based on the counterparty exposure limits. The definition of counterparty under regulatory framework of the Sultanate has focused on a single person and senior members in the management of Licensees and their related parties. The intention has been to specify limits, based on the net worth of Licensees, which would be the guiding factor for incremental asset / exposure build-up.

2.8.8 The approach of tracking only the Non Performing Credits does not signal the intrinsic quality of the entire asset book. Licensees should evolve proper systems for identification of credit weaknesses well in advance. Most of international banks have adopted various portfolio management techniques for gauging asset quality. The CRMD may be assigned the responsibility of periodic monitoring of the asset portfolio. The portfolio quality could be evaluated by tracking the migration (upward or downward) of counterparties from one internal rating scale to another. Data on movements within grading categories provide a useful insight into the nature and composition of the asset book. For all adverse movements in the credit quality over the life cycle of the exposure the Licensee would have to initiate specific surveillance arrangements and remedial measures to keep a close track of deteriorating credit quality.

2.8.9 The Licensees could also consider the following measures to maintain the portfolio quality:

2.8.9.1 Stipulate quantitative ceiling on aggregate exposure in specified rating categories, i.e. certain percentage of total advances in the rating category of 1 to 4 or 1 to 6, etc.
2.8.9.2 Evaluate the rating-wise distribution of counterparties in various industry, business and personal segments.

2.8.9.3 Exposure to one industry / sector should be evaluated on the basis of overall rating distribution of counterparties within the sector / group. In cases where a single industry / segment is badly performing in the portfolio or there is a concentration of counterparties in the lower notches of ratings, the Licensees may increase the quality standards for that specific industry / group.

2.8.9.4 Target rating-wise volume of Islamic Banking transactions, probable defaults and provisioning requirements as a prudent planning exercise. For any deviation/s from the expected parameters, an exercise for restructuring of the portfolio may immediately be undertaken and if necessary, the entry-level criteria could prudently be enhanced to insulate the portfolio from further deterioration.

2.8.9.5 Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes (e.g. slump in oil prices, global / country-specific slowdowns, international / domestic market risk events, extreme liquidity conditions, war situations, etc.). The stress tests would reveal undetected areas of potential credit risk exposure and linkages between different categories of risk. In adverse circumstances, there may be substantial correlation of various risks, especially credit and market risks. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated models. The Board should review the output of such portfolio-wide stress tests and suitable changes may be made in prudential risk limits for protecting the asset quality. Stress tests could also include contingency plans, detailing management responses to stressful situations.

2.8.9.6 Introduce discriminatory time schedules for review / renewal of counterparty exposures. Lower rated counterparties whose financials show signs of weakness should be subjected to renewal control twice / thrice a year.

2.8.10 Licensees may appoint Portfolio Managers to watch the asset portfolio’s degree of concentration and exposure to counterparties. For comprehensive evaluation of high value exposures, banks may consider appointing Relationship Managers to ensure that overall exposure to a single counterparty is monitored, captured and controlled. The Relationship Managers may service mainly high value counterparties so that a substantial share of the asset portfolio, which can significantly alter the risk profile, would be under constant surveillance. Further, transactions with affiliated companies / related parties need to be aggregated and monitored regularly. The banks should also put in place formalized systems for identification of accounts showing pronounced credit weaknesses well in advance,
prepare internal guidelines for such an exercise and set time frame for deciding courses of action.

2.9 Review Mechanism

2.9.1 A Review mechanism is an effective tool for constantly evaluating the quality of asset book and to bring about qualitative improvements in credit administration.

2.9.2 Licensees must put in place a proper review mechanism, at least for high value accounts with responsibilities assigned to various areas such as evaluating the effectiveness of credit administration, maintaining the integrity of credit grading process, assessing the general and specific loss provisions, portfolio quality, etc. The complexity and scope of review mechanism normally vary based on Licensees’ size, portfolio composition and management practices. It may be independent or part of the CRMD.

2.9.3 The main objectives of the review mechanism could be:

2.9.3.1 Evaluate credit approval process;

2.9.3.2 Review credit risk assessment;

2.9.3.3 Identify credits which exhibit weaknesses and suggest timely corrective measures;

2.9.3.4 Evaluate portfolio quality and isolate potential problem areas;

2.9.3.5 Provide inputs for determining adequacy of loss provisions;

2.9.3.6 Assess the adequacy of and adherence to credit policies and procedures, and monitor compliance with relevant laws and regulations;

2.9.3.7 Provide the top management with information on the quality of credit administration, including credit sanction process, risk evaluation and post-sanction follow-up.

2.9.4 Accurate and timely credit grading is one of the basic components of an effective review mechanism. Credit grading involves assessment of credit quality, identification of problem Islamic Banking transactions and assignment of risk ratings. A proper credit grading system should be designed to evaluate the portfolio quality and establish loss provisions. Given the importance and subjective nature, the credit ratings awarded by Credit Administration Department should be subjected to review by Credit Review Officers who are independent of credit administration.
2.9.5 Licensees shall formulate Credit Review Policy and the Board shall review it annually. The Policy shall, inter alia, address:

2.9.6 Qualification and Independence

2.9.6.1 The Credit Review Officers shall have sound knowledge in credit appraisal, financing practices, credit policies of the Licensee and Shari’a compliant banking with its financing concepts. They shall also be well versed in the relevant laws / regulations relating to financing activities. The independence of Credit Review Officers shall be ensured and the findings of the reviews shall also be reported directly to the Board.

2.9.7 Frequency and Scope of Reviews

2.9.7.1 The credit reviews shall provide feedback on effectiveness of credit sanction and to identify incipient deterioration in portfolio quality.

2.9.7.2 Reviews of high value credits shall be undertaken usually within three months of sanction / renewal or more frequently when factors indicate a potential for deterioration in the credit quality. The scope of the review shall cover all performing credits above a cut-off limit.

2.9.7.3 In addition, Licensees should also target other accounts that present elevated risk characteristics. At least 30-40% of the asset portfolio should be subjected to review in a year to provide reasonable assurance that all the major credit risks embedded in the balance sheet have been tracked.

2.9.8 Depth of Reviews

2.9.8.1 The credit reviews shall focus on:

2.9.8.1.1 Approval process;

2.9.8.1.2 Accuracy and timeliness of credit ratings assigned by credit officers;

2.9.8.1.3 Adherence to internal policies and procedures, and applicable laws / regulations;

2.9.8.1.4 Compliance with credit covenants;

2.9.8.1.5 Post-sanction follow-up;

2.9.8.1.6 Sufficiency of credit documentation;

2.9.8.1.7 Portfolio quality;

2.9.8.1.8 Recommendations for improving portfolio quality.
2.9.8.2 The findings of Reviews shall be discussed with line Managers and corrective actions shall be elicited for all deficiencies. Deficiencies that remain unresolved shall be reported to the top management.

2.10 Credit Risk in Investment Banking

2.10.1 Significant degree of credit risk, in addition to market risk, is inherent in Investment Banking. The proposals for investments shall also be subjected to the same degree of credit risk analysis as any regular financing proposal.

2.10.2 The proposals shall be subjected to a detailed appraisal and rating framework that factors in financial and non-financial parameters of issuers, sensitivity to external developments, etc. The maximum exposure to counterparty shall be bank-wide and include all exposures assumed by the Credit, Treasury, etc. departments. The credit spread on non-sovereign papers shall be commensurate with their risk profile. The Licensees shall exercise due caution, particularly in investment proposals which are not rated and should ensure comprehensive risk evaluation. There shall be sufficient interaction between Credit and Treasury departments and the portfolio analysis shall cover the total exposures, including investments. The rating migration of the issuers and the consequent diminution in the portfolio quality shall also be tracked at periodic intervals.

2.10.3 As a matter of prudence, Licensees shall stipulate entry level minimum ratings / quality standards, industry, maturity, issuer-wise limits in investment proposals to mitigate the adverse impacts of concentration and the risk of illiquidity.

2.11 Inter-Bank Exposure

2.11.1 During the course of business, Licensees often assume exposures on other banks on reciprocal basis in support of trade transactions, placements and transactional banking services such as clearing and custody. Licensees are natural counterparties for several transactions and it is, therefore, important that a proper credit risk assessment of the other banks is undertaken.

2.11.2 Licensees should evolve a suitable framework to provide a centralized overview on the aggregate exposure on other banks. Bank-wise exposure limits should be set on the basis of external or internal ratings.

2.11.3 Like corporate clients, banks could also be rated and placed in ranges of 1-4, 1-9, as the case may be, on the basis of their credit quality. The tier system enables a
Licensee to establish internal parameters to help determine acceptable limits to a particular banking group. The limits so arrived at should be allocated to various operating centres and followed up for half-yearly / annual reviews. Regarding exposure on overseas banks, Licensees could also factor in the country ratings of international rating agencies and classify the countries into low risk, moderate risk, satisfactory risk, acceptable risk, high risk, etc. The maximum exposure should be subjected to adherence of country and bank exposure limits already in place. The exposures - funded, off-balance sheet and payment systems - should be monitored on a real time basis.

2.12 Credit Risk in Off Balance Sheet Exposures

2.12.1 The mechanics involved in the assessment of non-funded lines shall be similar to the assessment of funded lines.

2.12.2 The possibility of such lines crystallizing into funded liabilities tends to be very high. Thus, utmost care must be taken whilst extending these facilities. Licensees should therefore evolve adequate framework for managing their exposure in off-balance sheet product as a part of overall credit to individual counterparty relationship and subject to the same credit appraisal, limits and monitoring procedures.

2.12.3 Licensees shall classify their off-balance sheet exposures into three broad categories - full risk (credit substitutes) - standby letters of credit, money guarantees, etc, medium risk (not direct credit substitutes, which do not support existing financial obligations) - bid bonds, letters of credit, indemnities and warranties, and low risk - repos etc. The trading credit exposure to counterparties can be measured on static (constant percentage of the notional principal over the life of the transaction) and on a dynamic basis, factoring day-to-day changes in the market value of the instruments. The total exposures to the counterparties on a dynamic basis should be the sum total of the current replacement cost (unrealized loss to the counterparty) and the potential increase in replacement cost (estimated with the help of Value at Risk (“VaR”) or other methods to capture future volatilities in the value of the outstanding contracts / obligations). The current and potential credit exposures may be measured on a daily basis to evaluate the impact of potential changes in market conditions on the value of counterparty positions. The potential exposures may also be quantified by subjecting the position to market movements involving normal and
abnormal movements in profit rates, foreign exchange rates, equity prices, liquidity conditions, etc.
3. **Country and Transfer Risk**

3.1 **Introduction**

3.1.1 *Cross-border exposures involve a number of risks. In addition to risks associated with the creditworthiness of counterparties, Licensees are exposed to other dimensions of risks - funding, profit rates, currency, settlement, etc., in cross-border exposures. Cross-border financing also involves country and transfer risk.*

3.1.2 *Country Risk refers to the possibility of sovereign counterparties of a particular country being unable or unwilling, and other counterparties unable, to fulfil their foreign obligations for reasons beyond the usual risks which arise in relation to all types of financing. Such risks are associated with economic, social and political environments of the counterparty’s home country. Country Risk is most apparent when financing to foreign governments or their agencies, since such financing is typically unsecured, but it is also important in respect of foreign credit or investment with public or private counterparties. Sovereign risk arises from the special risk associated with a sovereign credit, which is a credit to, or guaranteed by a government (and some government-guaranteed bodies). The special significance of such financing lies in the risk that it might prove impossible to secure redress through legal action, i.e., the counterparty might claim immunity from process or might not abide by a judgment.*

3.1.3 *Transfer Risk, on the other hand arises when counterparty’s obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the counterparties regardless of their ability to meet the obligations or financial condition.*

3.1.4 *Another element of Country Risk could be Contagion Risk which arises where an adverse development in one country leads to downgrade in rating or credit squeeze not only for that country but also other countries in that region, notwithstanding that those countries may be more credit worthy and that the adverse developments do not apply to them.*

3.2 **Policy Framework for Country Risk Exposures**

3.2.1 *Licensees shall have an appropriate policy framework approved by the Board of Directors for identifying, measuring, monitoring and controlling country and transfer risks, tailored to the size and complexity of their international exposures. The framework may include a system for risk assessment of countries, tolerance limits and monitoring with responsibility*
and accountability at various levels so as to facilitate effective management of exposures at the individual counterparty, country and portfolio levels. The policy framework shall be comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risk.

3.2.2 Licensees shall have internal Country Risk exposure limits linked either to their Net Worth or Total Assets, as they deem fit, for different risk categories. Licensees should also have contingency plans in place to deal with sudden changes in macro-economic and political conditions at the global level or specific regions or countries and have clear exit strategies to moderate the magnitude of Country Risk exposures.

3.2.3 The policy shall mandate strict KYC principles of the cross-border counterparties, which shall not be compromised by the backing of collateral or maturities of credits.

3.2.4 Management of Country Risk shall also incorporate stress testing as one method to monitor actual and potential risks. Stress testing shall include an assessment of the impact of alternative outcomes to important underlying assumptions.

3.3 **Measurement and Monitoring**

3.3.1 Licensees shall reckon both funded and unfunded exposures from their domestic as well as foreign branches while identifying, measuring, monitoring and controlling country risk. In the case of the branches of foreign banks operating in the Sultanate of Oman, the scope would be confined to their branches in Oman. Domestic banks having overseas operations need not reckon their exposures on home country. An illustrative list of funded and unfunded exposures that should be reckoned for measuring cross-border exposures is furnished below:

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3.3.21 In respect of foreign exchange contracts, exposure may be computed by reckoning the current exposure and potential future exposure. Further, commitments that are unconditionally cancellable at any time by the Licensee without prior notice or that effectively provide for automatic cancellation due to deterioration in a counterparty’s credit worthiness, need not be reckoned for the risk assessment.

3.3.22 The claims shall be allocated according to the residence of the counterparty / operations of the unit. Legally binding guarantees from a resident of a country other than that of the counterparty may be considered. Eligible collateral available in a country other than that of the counterparty may also be considered in the same manner as guarantees. In such cases, the exposures could be moved to the country of the guarantor and the location of the collateral.

3.3.23 Exposure to a country shall be considered as significant where the exposure is 1% or more of the total assets and off-balance sheet exposure of a Licensee. For such significant exposures, Licensees shall have more detailed assessment and monitoring framework.

3.3.24 Licensees shall also take into account indirect country risk. For example, exposures to a local commercial counterparty with large economic dependence on a certain country may be considered as subject to indirect country risk. Indirect exposures may be reckoned at 50% of the exposure for the purpose of these guidelines. For the present, only in respect of countries where the exposure is significant, a Licensee is required to reckon
indirect Country Risk exposures for measuring, monitoring and controlling the country risk.

3.3.25 Licensees shall have sound and well-defined credit-granting criteria and systems for monitoring the credit quality of individual credits and country-wise exposures in the portfolio. Licensees should also perform their own independent credit risk analyses and review of terms while participating in syndicated cross-border exposures. In respect of inter-bank or other exposures that are covered by netting agreements, the legal basis should be sound and enforceable.

3.3.26 Licensees are encouraged to use sound analytical techniques, such as internal credit rating, for measuring the full dimensions of risks inherent in country exposures. The techniques should help analyse the risk at the portfolio level as well. The rating system should also factor the linkages between credit and market risks and their impact on default probabilities of counterparties. The internal ratings should be mapped with those of the international rating agencies and the spirit should be that the internal ratings assigned to a country and / or counterparty should in no way be better than the ratings awarded by rating agencies.

3.3.27 In the absence of internal assessment of country risk, Licensees may use the ratings awarded by the External Credit Assessment Institutions ("ECAIs"), approved by the Central Bank for capital adequacy purposes.

3.3.28 The Central Bank encourages Licensees to review their Country Risk exposures in the light of the above and to exercise due care in assuming fresh exposures, particularly in respect of countries which may come under 'restricted credit / off-credit' category or countries which are not rated by rating agencies.

3.4 Provisioning for Country Risk Exposures

3.4.1 Licensees shall build general loss provisions on performing credits to meet the expected losses, while a graduated level of specific provisions has been mandated on non-performing financing transactions. As regards exposures of Licensees to country and transfer risks, at present, no minimum provisioning requirement is being mandated by the Central Bank.

3.4.2 However, Licensees are encouraged to build adequate general loss provisions for meeting the expected losses arising out of Country Risk exposures and such general loss provisions should ideally be determined on the basis of country ratings, credit ratings and the associated default probabilities, loss given defaults,
rating migrations, current macro-economic environment and other pertinent indicators.

3.4.3 The position would be reviewed by the Central Bank after examining the nature and extent of such exposures of Licensees for considering the appropriate level of provisions in due course. The Central Bank may also consider prescribing a prudential aggregate country exposure limit or a higher level of provisioning for the higher risk categories in respect of any Licensee where the exposures are observed to be excessive and / or the risk management systems are not commensurate to the level and complexity of the Country Risk exposures.

3.4.4 General loss provisions made voluntarily by Licensees for meeting the expected losses arising out of Country Risk exposures would be allowed to be included in Tier II capital as part of general provisions within the overall ceiling of 1.25% of total risk weighted assets.

3.5 Review of Policy and Exposures

3.5.1 The policies along with strategies of a Licensee as regards Country Risk exposures should be reviewed by the Board of Directors periodically to factor in the evolving risks. The frequency of periodic reviews of Country Risk ratings should be at least once a year with a provision to review the rating of a specific country, based on any major event in that country where exposure is high, even before the next periodical review of the ratings is due. The Board should review the position of Country Risk exposures at least on a half-yearly basis and more frequently depending upon the Licensee’s strategy and level of exposure. In case any significant deterioration takes place in respect of exposure to any particular country or overall exposure, the management of the Licensee should report to the Board such developments in its next meeting, without waiting for the periodical review by the Board.

3.5.2 Country Risk management processes employed by Licensees would require adequate internal controls that include audits or other appropriate oversight mechanism to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits.

3.6 Reporting of Country Risk Exposures

3.6.1 All licensed Licensees operating in the Sultanate should report details of their Country Risk exposures to the Banking Surveillance Department of
Central Bank of Oman on a quarterly basis in the attached format and the reports are to be submitted within one month from the reporting date.

3.6.2 Licensees should disclose the aggregate Country Risk exposures together with the aggregate provisions (voluntarily set aside) in the annual financial statement for providing transparency.
4. Connected / Related Parties and Other Exposures Limits

4.1 Introduction

4.1.1 The measure of credit exposure shall encompass the maximum amount of credit risk arising from both actual claims and potential claims of all kinds. Thus, the measure of exposure should include:

4.1.1.1 All funded facilities;

4.1.1.2 The par (100%) values of credit substitutes, such as guarantees, acceptances, letters of credit, other transactions with recourse, and all other forms of contingent liabilities, notably credit commitments, which are not cancellable;

4.1.1.3 The credit equivalent amount used for determining regulatory capital in respect of contracts, such as forward contracts, forward rate agreements, etc, where the Licensee is not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flows (on contracts showing positive value) if the counterparty defaults.

4.1.2 Thus, the measure should reflect the maximum loss that could arise should the counterparty fail or the loss that may arise in the realization of any assets, or other exposures or off-balance sheet positions.

4.1.3 Exposures also include investment exposure (investments, underwriting commitments, etc). As a general rule, all exposures are determined on a gross basis without netting credit risk mitigants, loss provisions and interim profits. Further, the authorized limits or outstanding amounts, whichever are higher, are reckoned for determining the exposures. However, in the case of fully drawn Islamic Banking facility, where there is no scope for re-drawl of any portion of the authorized limit, the outstanding amount could be reckoned as credit exposure.

4.1.4 Licensee’s exposure to securities trading operations is calculated as its net long position in a particular security (a long position in a security should not be netted off against a short position in another issue of the same issuer). The net position in a security refers to the commitment to buy a security together with its current holding of the security, less its commitment to sell the security.

4.1.5 The total exposure to a connected counterparty or a related party is determined by aggregating the exposures computed as above.
4.2 Definition of Connected Counterparty and Related Party

4.2.1 Proper identification of potential linkages between exposures to Licensees’ counterparties is important for restricting credit concentrations. It is quite possible that separate counterparties, despite dealing on an independent basis with Licensees, represent a single risk inasmuch as they are so interconnected legally or economically with the likelihood that if one of them experiences financial difficulties, the other or all of them are likely to encounter problems. Thus, repayment difficulties could arise for all parties if any one of them experienced financial problems. The relationship should ideally, therefore include connection through close family relation / common ownership / control / management, cross-guarantees and direct commercial interdependency which cannot be substituted in the short-term.

4.3 Group of Connected Counterparties

4.3.1 Group of connected counterparties is a group of persons and / or companies related financially or by close family relation, common ownership, management or any combination thereof constituting a single risk. Further, two or more natural or juristic persons would be considered as connected even if there is no relationship of control between themselves, as indicated above, but who are regarded as constituting a single risk, as they are so interconnected (captive customers or suppliers) that, if one of them were to experience financial problems, the other/s would likely encounter payment difficulties.

4.3.2 Licensees may assess a group of connected counterparties by treating one of the connected counterparties as the ‘principal’ (who is a natural or juristic person) and by determining other counterparties with reference to the principal connected party. A connected counterparty thus may comprise of:

4.3.2.1 The ‘principal’ connected party (a natural or juristic person);

4.3.2.2 Associates of the principal connected party, where the associates include close member of the family i.e. parents, spouses, sons and daughters, including legal adoptions and business entities wherein 25% or more of the voting power is controlled individually or collectively with the associates;

4.3.2.3 Associates of the principal connected party, where the associates include parent company, subsidiaries, fellow subsidiaries and other business entities
where the concerned juristic person owns or controls either directly or indirectly 25% or more of the voting power.

4.3.2.4 Persons or companies that have dependence economically or operationally on the principal connected party, as a major customer or supplier, which cannot be substituted in the short-term.

4.4 Related Parties

4.4.1 The related parties include Licensee’s subsidiaries and affiliates, and any other parties that the Licensee exerts control over or a party that exerts control over the Licensee. It also includes the Licensee’s major shareholders, directors, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.

4.4.2 The related parties for a Licensee would include:

4.4.2.1 Chairman and Directors on the Boards, SSB members including proxy Directors;

4.4.2.2 Parent entities, subsidiaries and fellow subsidiaries of the Licensee;

4.4.2.3 Chief Executive Officer and other line management – Deputy Chief Executive, General Managers, Deputy General Managers, Assistant General Managers and any other key management personnel (only those having authority and responsibility for planning, directing and controlling the activities of the Licensee, directly or indirectly) who are reporting directly to the Board or the CEO.

4.4.2.4 Any natural / juristic person who holds or controls, directly or indirectly, 10% or more of the voting power of the Licensee.

4.4.2.5 An associate of any of the natural persons includes close member of the family i.e. parents, spouses, sons and daughters, including legal adoptions and business entities wherein 25% or more of the voting power is controlled individually or collectively with the associates.

4.4.2.6 An associate of any juristic person includes parent company, subsidiaries, fellow subsidiaries and business entities where the concerned juristic person controls 25% or more of the voting power. It also includes companies whose majority of the Directors acts as per the wishes of the concerned company.
4.4.3 Licensee may consider the above definitions as the minimum for establishing linkages amongst the connected counterparties or related parties. In real practice, it is possible that a few customers may disguise linkages between two or more parts of the same connected group. Licensees should, therefore, strengthen their surveillance mechanism in detecting subterfuges designed to disguise relationships between counterparties.

4.5 Prudential Limits on Large Exposures

4.5.1 The international best practice on limiting large exposures envisages that credit exposures are fixed in relation to Licensees’ capital funds, as defined under capital adequacy. The credit exposure limits in the Sultanate are expressed in terms of the Licensees’ total capital (Tier 1, Tier 2) or global net worth, as approved by the Central Bank. Tier 1 and Tier 2 of the capital structure are defined in the Article 2.5 in the title on Capital Adequacy.

4.5.2 Licensees shall not assume exposures to connected counterparties or related parties beyond the prudential limits set for them.

4.5.3 The credit policy shall delineate the philosophy and approach on the management of credit concentration.

4.5.4 The aggregate exposure to a connected counterparty shall not at any time exceed 15% of the total capital of a Licensee. Such single obligation limit for the window will be 15% of capital of the bank – subject to bank as a whole not exceeding this limitation.

4.5.5 In the case of a related party, the total credit exposure shall not at any time exceed 10% of the total capital and that the aggregate of credit exposure to all the related parties shall not exceed 35% of a Licensee’s total capital.

4.5.6 The aggregate exposures of overseas branches of domestically incorporated Licensees to a connected counterparty, who is a resident in the respective countries of operations, shall not exceed 5% of the total capital (global net worth) or the single obligor legal financing limitation imposed by the host supervisory authority, whichever is less.

4.5.7 Exposures to related parties are justified only when undertaken for the clear commercial advantage of Licensees and should be extended on an arm’s length basis. Thus, any exposures to related parties, in the nature of capital investments or made particularly on favourable terms (not on arm’s length commercial basis) – with relaxation in risk assessment, profit rates, amortization schedules, requirement of collateral, etc., should be deducted
from Tier 1 capital of Licensees. Licensees are also precluded from financing to their own external auditors or to any partners thereof or to any of the employees of such audit firms.

4.5.8 In addition to the above prudential norms the Licensee should ensure, in line with the Shari’a ruling of its SSB, that the ultimate buyer / seller of a service or an asset is not a related party of the first seller / buyer.

4.6 Exceptions on Large Exposures

4.6.1 The limitations on exposures to connected counterparties and related parties do not apply to:

4.6.1.1 Exposures secured in cash or in cash equivalent not subject to withdrawal;

4.6.1.2 Exposures guaranteed by standby letters of credit or warranties or participations or repurchases, etc. in a manner satisfactory to the Central Bank, by a Licensee or financial institution within or outside the Sultanate;

4.6.1.3 To the extent that the payment of the principal and profit of such exposures has been guaranteed by the Government of the Sultanate or any Ministry thereof;

4.6.1.4 Inter-bank exposures;

4.6.1.5 Exposures arising from underwriting obligations which are held in the trading book.

4.6.2 Any exceptional investments or underwriting relating to related parties shall require prior approval from the Central Bank.

4.7 Large Joint Venture Projects

4.7.1 Certain large projects involving large outlay of funds are being executed in the Sultanate in the core sectors (as mentioned below) towards promoting the overall development of the country. These projects are expected to be self-supporting with high internal rate of return and are generally managed professionally with substantial foreign collaboration and / or investment. The amounts involved in such projects are substantial and may involve significant Licensee financing with some Government participation. A special treatment for financing of such projects is considered necessary in the context of their national importance and low credit risk.
4.7.2 The proposals, which comply with the following conditions, shall be treated on a standalone basis, subject to specific prior approval of the Central Bank, without aggregating with the credit exposures of local groups or sponsors or partners / promoters:

4.7.2.1 Significant shareholding by the Government of the Sultanate of Oman and / or reputable international bodies;

4.7.2.2 The projects should be in the core sectors, such as power, roads, telecommunication, seaports, airports, industrial / knowledge parks, fishing, tourism, health, education, water treatment, LNG, fertilizers and petrochemicals;

4.7.2.3 The projects should be viable, supported by strong cash flows and financials;

4.7.2.4 The local partners’ equity stake in the project should not exceed 49% of the total paid-up capital;

4.7.2.5 The creditworthiness and / or default history of the local partners should be satisfactory;

4.7.2.6 The overseas partners should have strong financials and have sound experience in the proposed projects;

4.7.2.7 The maximum exposure per project should not exceed 15% of the net worth of a Licensee; and

4.7.2.8 The maximum maturity of the financing facilities should not exceed 15 years and should be financed out of long-term sources of funds to avoid serious asset liability mismatches.

4.7.3 Licensees may approach the Central Bank with necessary details about the proposals, particularly the shareholding pattern, technical expertise of the foreign collaborator, projected cash flows and profitability, Licensee’s risk assessments, etc. for seeking prior permission for not aggregating the exposure to such projects with that of the local partners / sponsors / promoters.

4.8 Exposures to Government Companies

4.8.1 The Government of the Sultanate has been promoting companies, either as fully owned or majority or minority owned, in green field projects in sectors like oil, gas, fertilizers and other downstream areas. These companies serve to diversify the economy and also generate employment opportunities.
4.8.2 Considering the significant role played by such companies in the overall development of the economy and potentially lower credit risk associated with such projects, the Central Bank shall consider, on a case-by-case basis, the Licensees’ proposals to assume exposures up to a maximum of 25% of their total capital, provided the Government holds, either directly and / or indirectly, a minimum of 25% of the shareholdings in such companies.

4.8.3 The additional exposure is allowed, on specific references, with necessary details about the proposals, particularly the shareholding pattern, project specifics, projected cash flows and profitability, Licensees’ risk assessment, etc. to the Central Bank. The exposures to such counterparties that are in the core sectors (as indicated in 4.7.2.2) need not be aggregated with the local groups / partners / sponsors.

4.9 **Exposures to SAOG Companies**

4.9.1 *In the normal course, exposures to connected counterparties / related parties should be aggregated and the total exposures should be within the prudential limits. However, SAOG companies are generally run on professional lines and are more transparent in their operations.*

4.9.2 Credit exposures to SAOG companies need not be aggregated with the exposures of connected counterparties / related counterparties and may be reckoned as a single risk, on a standalone basis. However, the prudential limits, as relevant, should be applied on a standalone basis.

4.10 **Substantial Exposure**

4.10.1 The aggregate substantial exposure i.e. funded and non-funded exposure individually of 10% or more of the total capital of the Licensee, on a gross basis without adjusting for the credit risk mitigants, to all the connected counterparties and all the related parties shall not exceed 600% of the total capital of a Licensee.

4.10.2 Licensees shall have no discretion in incurring credit exposures, in excess of the above limits, without the prior approval of the Central Bank.

4.11 **Financing Ratio**
4.11.1 No Islamic Bank shall finance whether by giving credit, discounts, advances and/or overdrafts whether secured or unsecured when such financing in aggregate exceeds the applicable ratio of its deposits.

4.11.2 The financing ratio limitation applicable for all Licensees in the Sultanate is 87.5%.

**4.12 Other Credit Concentrations**

4.12.1 Apart from concentration of credit to counterparties, significant exposure, particularly to economic sectors makes the Licensees vulnerable to weakness in a particular industry/sector. Licensees should, therefore, systematically identify and measure their exposures to different sectors, regions, countries, currencies, etc. and if necessary adjust the portfolio to moderate the risk profile. The credit policy should stipulate prudential limits on exposures to sectors/industry/region/country, having regard to the performance of different sectors and the perceived risks, which may help Licensees to evenly spread their exposures over various sectors. The risk management policies and procedures should establish thresholds for acceptable credit concentrations. The prudential limits should be revisited at periodical intervals to capture evolving situations.

4.12.2 The large exposure limits are not applicable to the credit exposures on other banks. Licensees are expected to put in place appropriate exposure limits on other banks, considering their financial strength, rating, etc. However, banks’ exposure in the form of credit risk mitigants exacerbates the concentration problem. Banks may extend guarantees, back to back guarantees, standby letters of credit, warranties, participations, etc. on behalf of their counterparties and associates in Oman or overseas as credit risk mitigants against credit facilities extended in excess of large exposure limits. In order to avoid concentration of such credit risk mitigants, indemnifying banks should limit such facilities to each beneficiary bank up to 25% of the indemnifying bank’s total capital.

**4.13 Maximum Limit of Investment in Sovereign Sukuk**

4.13.1 Licensees are allowed to invest in Oman Sovereign Sukuk to a maximum permissible limit of 30% of a Licensee’s net worth.

**4.14 Financing to Central Bank Employees and Government Officials**
4.14.1 The Central Bank’s employees and Government officials applying for financing facilities from a Licensee should not be given any preferential treatment and they should be treated in the same way as any other clients.

4.14.2 In case of recovery of outstanding dues, Licensees should follow and implement the same procedure as applicable to other clients, in accordance with the rules and procedures of the Sultanate and as approved by their Shari’a Supervisory Boards.

4.15 Financing to Individuals for Non-Business Purposes

4.15.1 Quantitative ceiling of above facilities, excluding housing financing but including credit card facilities shall not exceed 40% of total credit. Housing Finance extended is limited to 10% of total credit.

4.15.2 The profit rate of licensee shall not exceed 7% per annum for the above facilities. The application/documentation/processing fees shall not exceed RO 25/- in respect of non-housing personal financing and RO 50/- on housing financing. Any penalty charged, permissible and reckoned in accordance with Shari’a, shall not exceed 1% on defaults. There shall be clarity in prior understanding/documentation and required approvals.¹

4.15.3 Profit rates on Credit Card facilities should be limited to 18% per annum for persons whose salary is transferred to the Licensee and 20% per annum for all others.

4.15.4 In the case of vehicle financing, there shall be minimum 20% down-payment of the cost by the customer and licensee shall arrange for takaful covering life and total disability of the customer. Comprehensive takaful should not be insisted upon.

4.15.5 Licensee should take into consideration the overall debt burden and serviceability before extending such facilities to customers. The maximum debt burden on non-housing personal financing and housing financing should not exceed 50% and 60% of net salary respectively. The maximum period of non-housing personal financing and housing financing should not exceed 10 years and 25 years respectively. In the case of non-housing personal financing, the top-up can be made available only after 24 months of satisfactory conduct of existing financing or after 50% of existing financing is repaid or when full eligibility hereunder had not been availed.²

4.15.6 In case of credit cards linked to salary the maximum limit than can be granted will be two times of the monthly salary for classic cards and three
times of the monthly salary or RO 2000, whichever is higher, the case of Gold Cards.

4.15.7 If a Licensee decides, at its discretion, to issue more than one type of credit card to an individual whose salary/end of service benefit is linked to the facilities so provided, the aggregate of limits thereof should not exceed five times of the monthly salary.

4.15.8 Licensee should have appropriate internal management system to plan and control all such facilities appropriately. Audit and compliance will discharge respective responsibilities in this regard.

4.15.9 Licensees shall also submit quarterly reports, indicating the profit rate charged on credit card outstanding, to VP, BCDs and Legal by 10th day of the following month after the end of the quarter.

4.15.10 Licensees shall ensure accuracy of data submitted to the Central Bank in this regard in view of implications for policy formulations.

4.16 Moderation on Real Estate Exposure

4.16.1 Central Bank underscores the sensitivity of the real estate sector in the light of global experience and calls for continued caution and the need for moderation to avoid excess capacity.

4.16.2 Licensees shall avoid financing for housing in the form of shorter term non-housing financing in view of the risks of serviceability/asset quality.

4.16.3 Licensees shall ensure prudence in all financing and not treat the ceiling limits, under any category, as entitlements.

4.16.4 Licensees shall maintain continued vigil in property sector taking into consideration genuine needs and absorbing capacity of the market, evolving policies and procedures with self-imposed limits and periodical reviews.

4.17 Financing Initial Public Offering

4.17.1 Licensees should not extend finance more than 50% of cost of Initial Public Offering (IPO) subscriptions and such subscriptions should not be treated as deposits for lending ratio entitlement.

4.18 Obtaining Audited Financials from the Customer
4.18.1 Licensee shall obtain audited financials from a customer for facility of RO 250,000 and above.

4.18.2 Licensee shall obtain audited financials from a customer with facilities of RO 500,000 and above from the system as a whole.

4.18.3 100% government owned companies are exempted from the requirement of submission of audited financial statements.

4.18.4 Licensees shall insist on submission by all customers who have been extended financing as a prudential measure for maintaining good asset quality.

4.19 Indemnity Agreements

4.19.1 Any exposure in excess of the connected party exposure limits of 15% and related party exposure limits of 10% of the total capital could be covered by eligible collaterals, indemnity guarantee, back to back guarantees, standby letters of credit, warranties, participation, etc. obtained by Licensees, acceptable to the Central Bank.

4.19.2 Guarantees / indemnities issued in favour of a customer shall be aggregated along with any other facility provided by the indemnifying Licensee to the same customer, for adherence to the connected party or related party financing limits.

4.19.3 Licensees are responsible for proper legal documentation of the indemnity agreements or other credit risk mitigants. The Central Bank has drawn up a Proforma Indemnity Agreement (Annexure 1), which provides the minimum essential coverage for the use of Licensees. The Licensees may make suitable changes / additions in consultation with their lawyers to the document. Licensees should also exercise caution in proper execution of the documents including thorough verification of signatories for safeguarding their interests.

4.19.4 The aggregate amount of the indemnity and other risk mitigants, covered by various agreements, shall not at any time exceed 25% of the indemnifying / credit protection providing Licensee’s total capital.

4.20 Reporting

4.20.1 Exposure to connected counterparties, in excess of 10% of the total capital of a Licensee, without adjusting for the eligible collaterals and other credit risk mitigants shall be reported in the attached format (Attachment 7.2), on a
quarterly basis. Exposure to related parties shall be reported on a quarterly basis in the enclosed format (Attachment 7.3). Licensees shall also report, on a quarterly basis, the indemnities and other risk mitigants issued / obtained (as per Attachment 7.4).

4.21 Board Responsibilities

4.21.1 The Board of Directors is primarily responsible for monitoring credit concentrations and devising such measures including articulation of appropriate credit policies and credit review mechanism for ensuring that the concentrations are well within the laid down policies and regulatory requirements. The Board of Directors should always endeavour to ensure a balanced composition of their Licensee’s asset book. The Board should also put in place appropriate MIS to assess and manage credit concentrations on a timely basis.
5. Financing to Non-Residents and Placements of Bank Funds Abroad

5.1 Introduction

5.1.1 Financings to non-residents and placements of funds outside the Sultanate of Oman involve the Licensees assuming higher degree of country, transfer, credit, currency, reputational and legal risks and have multiple implications for Oman, the Central Bank and the Licensees. Licensees are also exposed to heightened competition in the international financial markets. At the same time, it may not be prudent to preclude Licensees from tapping gainful cross-border business opportunities in the context of liberalization and globalization. Under these circumstances, it is necessary to mitigate the underlying risk of such exposures through prudential regulations and risk limits, for maintaining financial stability and solvency of the licensed Islamic Banks.

5.2 Financing to Non-Residents in Rial Omani

5.2.1 Licensees shall not invest in or finance non-resident banks in Rial Omani, which should, inter alia, include the Head Office, branches of such Licensee outside the Sultanate, affiliates or subsidiary companies thereof.

5.2.2 Licensees are not allowed to grant financing denominated in Rial Omani to non-resident companies, individuals or other entities.

5.2.3 The Embassies, Consulates and persons of diplomatic status within the Sultanate shall not be regarded as non-residents for the purpose of the above norms.

5.2.4 These measures shall not, in any way, affect the right of any person, other than Licensee, to transfer or hold Rial Omani balances, assets or other currencies outside the Sultanate of Oman.

5.3 Financing to Non-Residents in Foreign Currencies for Operations Abroad

5.3.1 An analysis of the risk profile of financings to non-residents in foreign currencies for operations abroad reveals heightened supervisory concerns and hence, with a view to enhance the safety and soundness of Licensees, the following specific guidelines are issued:
5.3.1.1 Any exposures of US$ 5 million and over to any non-resident counterparties shall, be assumed only through the route of syndication.

5.3.1.2 The aggregate of direct and indirect exposures to a non-resident counterparty and his related parties by overseas branches of a domestically incorporated Islamic Bank shall not exceed 5% of the domestic net worth of the financing bank or single counterparty limits imposed by the host country supervisor, whichever is less.

5.3.1.3 The aggregate of direct and indirect exposures to a non-resident counterparty and his related parties, by a domestically incorporated Islamic Bank including that of its overseas branches shall not exceed 2.5% of the domestic net worth of the financing bank.

5.3.1.4 The aggregate financings to all non-resident counterparties and their related parties by a domestically incorporated Islamic Bank including that of its overseas branches shall not exceed 20% of the domestic net worth of the financing bank.

5.3.1.5 The aggregate exposure of the domestically incorporated Islamic Bank including the financings by overseas branches to a resident and/or his related parties in Oman shall not exceed 15% of the global net worth of the bank.

5.3.1.6 The aggregate of direct and indirect exposures to a non-resident counterparty and his related parties, by foreign banks operating in the Sultanate shall not exceed 5% of their domestic net worth. The aggregate financings to all non-resident counterparties and their related parties, by the foreign banks shall not exceed 20% of their domestic net worth.

5.3.1.7 Licensees shall fix prudential limits on country exposures to mitigate the adverse effects of country risk.

5.3.1.8 Licensees shall monitor very closely the currency risk assumed by their non-resident customers to avoid market risk triggered credit risk.

5.3.1.9 Exposures to customers having residency and/or operations in countries, which are rated below investment grade by international rating agencies, shall be backed by adequate collateral and strong financials.

5.3.1.10 Licensees shall report the details of the credit facilities granted in foreign currency to non-residents as per Annexure 5 and details of syndicated financing, both for resident and non-resident counterparties, as per Attachment 7.6 within 15 days of the end of each quarter.
5.4 Placement of Bank Funds Abroad

5.4.1 The placement of Licensee funds abroad is governed by the following guidelines:

5.4.2 Branches of Foreign Banks Operating in the Sultanate:

5.4.2.1 The aggregate of all foreign currency balances with the offices indicated below shall not exceed 60% of the domestic net worth and shall be segmented further within the following ceilings:

<table>
<thead>
<tr>
<th>Offices with which the Foreign Currency Balance is Maintained</th>
<th>Ceiling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Head Office and Own Branches Abroad (aggregate)</td>
<td>20% of the domestic net worth</td>
</tr>
<tr>
<td>At each Head Office Affiliate Abroad</td>
<td>20% of the domestic net worth</td>
</tr>
</tbody>
</table>

5.4.3 Domestic Banks:

5.4.3.1 The aggregate of all foreign currency balances with the offices indicated below shall not exceed 60% of the domestic net worth and shall be segmented further within the following ceilings:

<table>
<thead>
<tr>
<th>Offices with which the Foreign Currency Balance is Maintained</th>
<th>Ceiling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal Shareholders and their own Offices / Branches Abroad (aggregate)</td>
<td>20% of the domestic net worth</td>
</tr>
<tr>
<td>At each affiliate of Principal shareholders Abroad</td>
<td>20% of the domestic net worth</td>
</tr>
<tr>
<td>Branches of Domestic Banks Abroad (aggregate)</td>
<td>20% of the domestic net worth</td>
</tr>
</tbody>
</table>

5.4.3.2 The ceiling stipulated herein refers to the sum total of all balances, including the balances in Nostro accounts (before netting with dues to respective offices) booked in the Head Office, branches, affiliates abroad, and in the case of domestically incorporated Islamic Banks, all principal shareholders, affiliates and branches abroad.

5.4.3.3 Domestically incorporated Islamic Banks issuing Letters of Credit (LCs) in large amounts, for and on behalf of their customers, and for which they require confirmation from their principal shareholders or affiliates thereof, are exceptionally authorized to deposit with such principal shareholders or
affiliates a maximum of 50% of the amounts of such LCs over and above the limits as prescribed in the above article.

5.4.3.4 For the purpose of placement of funds abroad, the following definitions shall apply:

5.4.3.4.1 Principal Shareholders in the case of domestically incorporated Islamic Banks refer to any non-resident bank that holds equity ownership of 15% or more of capital issued and outstanding of the domestic Islamic Bank.

5.4.3.4.2 Affiliates means a Licensee having 30% or more of the voting shares in the equity of the concerned and its affiliates.

5.4.3.4.3 A Head Office Affiliate in the case of Foreign Banks and Principal Shareholder’s Affiliate in the case of domestic Islamic Banks mean an institution in which the Head Office or the Principal Shareholder as the case may be owns 30% or more of the voting shares of the affiliate.

5.4.3.4.4 Issuing LCs in large amounts refers to the amount that exceeds Rial Omani one million for every one LC.

5.4.3.5 Licensees shall report the details of placement of their funds abroad as per Attachment 7.7 within 10 days after the end of each month.
6. Risk Classification

6.1 Introduction

6.1.1 Asset quality is the key driver that determines the stability of the banking system. Accordingly, Licensees should have appropriate systems to grade the credits on the basis of well-defined credit weaknesses for providing useful insights into the nature and composition of the credit book. While Licensees have multiple tiers, consistent with their risk management policies, procedures and practices for risk classification, for the purpose of regulatory reporting and credit loss provisioning, they should uniformly follow, for the present, a five-tiered risk classification system - Standard, Special Mention, Substandard, Doubtful and Loss. The parameters for risk classification are a mix of quantitative and / or qualitative characteristics. Further, Licensees should follow a separate set of parameters for risk classification of retail and commercial credits.

6.2 Criteria for Classification of Retail Credits

6.2.1 The retail credits include all personal financing, consumer financing, auto financing and leases, educational financing, medical financing, and credit card dues, irrespective of the size of the credit sanctioned.

6.2.2 Residential mortgages, small business facilities and any other exposures where the sanctioned limits do not exceed RO 50,000 are also treated as retail credits for the limited purpose of risk classification. Credits in excess of RO 50,000 from these categories should be treated as commercial credits for the purpose of risk classification.

6.2.3 Licensees should use quantitative parameters for the risk classification of retail credits.

<table>
<thead>
<tr>
<th>Category</th>
<th>Parameter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard</td>
<td>Meeting all the payment obligations or remain past due for less than 60 days.</td>
</tr>
<tr>
<td>Special Mention</td>
<td>Remain past due for 60 days or more but less than 90 days</td>
</tr>
<tr>
<td>Substandard</td>
<td>Remain past due for 90 days or more but less than 180 days</td>
</tr>
<tr>
<td>Doubtful</td>
<td>Remain past due for 180 days or more but less than 365 days</td>
</tr>
<tr>
<td>Loss</td>
<td>Remain past due for 365 days and over</td>
</tr>
</tbody>
</table>
6.3 Criteria for Classification of Commercial Credits

6.3.1 Commercial credits include all credits and advances which are not categorized as retail financing. Such credits are classified into various risk categories on the basis of quantitative and/or qualitative parameters. The quantitative parameter i.e. payments past due for a specified number of days, should be considered only as a threshold and credits which exhibit early signs of defaults should appropriately be classified, notwithstanding the fact that the credits are not past due for the period specified under different categories of risk classification. Further, the characteristics listed out for risk classification of various categories are not exhaustive and Licensees should grade all credits meticulously to capture the downside risks and classify the credits proactively into the following appropriate risk categories.

6.3.2 Standard

6.3.2.1 All credits and advances, where payments of the principal and/or profit are current and have no indications of financial or other weaknesses and are not classified as Special Mention or Substandard or Doubtful or Loss, are categorized as Standard.

6.3.3 Special Mention

6.3.3.1 Special Mention credits are those which exhibit potential weaknesses that deserve Licensee management’s pre-emptive actions to enhance the present quality of the assets. The Special Mention credits are potentially weak credits where, if left uncorrected, the weakness may result in deterioration of the repayment prospects for the credits or Licensee’s credit position at some future date. Such credits are not adversely classified and do not expose a Licensee to sufficient risk to warrant adverse classification. The Special Mention category shall not be used as a means of avoiding adverse risk classification of credits or for passing it without criticism.

6.3.3.2 The general characteristics of Special Mention credits are as follows:

6.3.3.2.1 Early signs of cash flow/liquidity problems such as delay in servicing of trade creditors/credits.

6.3.3.2.2 Inadequate or unreliable financial and/or other information such as audited financial statements not obtained or are not available.

6.3.3.2.3 The condition of and control over collateral is unsatisfactory.

6.3.3.2.4 Frequent changes in senior levels of management.
6.3.3.2.5 Failure to obtain proper documentation or non-cooperation by the counterparty.

6.3.3.2.6 Slowdown in business or adverse trend in the operations that signals a potential weakness in the financial strength of the counterparty, which has not reached a point where servicing of the credit is jeopardized.

6.3.3.2.7 Intra-group transfer of funds without underlying transactions.

6.3.3.2.8 Exposures to related parties on favorable terms.

6.3.3.2.9 Volatility in the economic or market conditions which may, in future, affect the counterparty adversely.

6.3.3.2.10 Poor performance in the industry in which the counterparty operates.

6.3.3.2.11 Counterparty is the subject of litigation by third parties that may have a significant impact on its financial position.

6.3.3.2.12 Remain past due for 60 days or more but less than 90 days.

6.3.4 Substandard

6.3.4.1 The Substandard credits are credits which have well defined credit weaknesses, where the current sound worth and paying capacity of the counterparty is not assured and the timely repayment of the obligations is in jeopardy. They are characterized by the distinct possibility that the Licensee may sustain some loss unless the deficiencies are corrected.

6.3.4.2 Credits possessing any of the following characteristics are classified as Substandard.

6.3.4.2.1 Inadequate cash flows and / or defects in credit documentation.

6.3.4.2.2 Inadequate and / or unhealthy operations in the account.

6.3.4.2.3 Imminent probability of foreclosure or acquisition of collateral.

6.3.4.2.4 Failure to clear temporary or short-term facilities.

6.3.4.2.5 Frequent rollovers and / or renewals without definite source/s of repayment.

6.3.4.2.6 Adjusting delinquency by creating fresh facilities and / or allowing excess drawings in other related concerns’ or individual accounts.

6.3.4.2.7 Significant negative trends in financial statements - deterioration in account receivables, declines in net worth and profitability, build-up of inventories, liquidity problem, etc.

6.3.4.2.8 Credits under dispute and recovery measures are being contemplated.
6.3.4.2.9  Remain past due for 90 days or more but less than 270 days.

6.3.5  Doubtful

6.3.5.1  Doubtful credits are credits that exhibit all the weaknesses inherent in substandard credits with the added characteristic that collection or liquidation, in full, on the basis of currently known facts, conditions and values, is highly questionable and improbable.

6.3.5.2  Credits possessing any of the following characteristics are classified as Doubtful:

6.3.5.2.1  All or most of the weaknesses of credits classified as substandard.

6.3.5.2.2  A loss exposure that cannot be readily defined with present circumstances and conditions.

6.3.5.2.3  The weaknesses, on the basis of existing facts, conditions and values, have rendered the collection or liquidation in full highly questionable and improbable.

6.3.5.2.4  Legal action initiated.

6.3.5.2.5  Remain past due for 270 days or more but less than 630 days.

6.3.6  Loss

6.3.6.1  Loss credits are credits that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer full provision or writing off this basically worthless credit even though partial recovery may be effected in future.

6.3.6.2  Credits possessing any of the following characteristics are classified as Loss:

6.3.6.2.1  Severe delinquency.

6.3.6.2.2  The counterparty’s whereabouts are unknown, or he is insolvent, or his earning power is permanently impaired and the guarantees are not financially supported (not collateralized).

6.3.6.2.3  The collateral is worthless or undetermined value of collateral.

6.3.6.2.4  Credits considered by the management of the Licensee as absolutely uncollectible.

6.3.6.2.5  Remain past due for 630 days or more.
6.3.7 Non-Performing Assets (NPAs)

6.3.7.1 All credits and advances which are classified as Substandard, Doubtful and Loss shall be categorized as Non-Performing Assets (NPAs).

6.3.7.2 A credit where repayments of principal and profit are pre-determined is considered as past due when they have not been paid on the due date fixed by the Licensee as per the terms of contract.

6.3.7.3 Credit facilities like overdrafts, lines of credit, etc. where no definite repayments are pre-determined are treated as past due (out of order) if the outstanding balance remains continuously in excess of 10% of the sanctioned / authorized limit or in cases where the outstanding balance in the principal operating account is less than the sanctioned / authorized limit, but there are not enough credits in the account to cover the profit charged or unauthorized drawings have frequently been allowed.

6.3.7.4 Bills which remain unpaid on due dates are considered as past due.

6.4 Risk Classification and Collateral Support

6.4.1 Collateral support or other risk mitigation techniques shall not influence the risk classification of credits. The classification shall be carried out with reference to the credit weaknesses, financial status of the guarantors, etc.

6.5 Classification of Off-Balance Sheet Exposures

6.5.1 Off-balance sheet exposures - credit commitments, guarantees, letters of credit, stand-by letters of credit, etc. also involve credit risk arising from the possibility that the creditworthiness of the counterparties could deteriorate after the original commitment is made.

6.5.2 Off-balance sheet exposures shall also be treated the same way as credits for risk classification.

6.5.3 When apparent signs of weaknesses that jeopardize repayment are visible, such exposures are classified accordingly. The exposures are separated into two components - the direct amount (the amount that has already been advanced) and the indirect amount (the amount that might be advanced in the future).

6.6 Restructured Credits
6.6.1 Under Shari’a principles an Islamic financier is expected to respect the difficulties a customer is facing in repaying an obligation. Licensees should consider restructuring of financing after careful analysis and also ensure that such restructuring doesn’t lead to moral hazard or a continuous problem for the Licensee.

6.6.2 Restructured or rescheduled credits are credits that have been modified on favourable terms and conditions for the counterparty, after establishing the counterparty’s financial condition or ability to repay. Restructuring also includes modification of terms, such as reduction in profit rate or principal amount, transfer of collateral and acquisition of equity interest, in full or partial satisfaction of the credit, etc.

6.6.3 The terms of restructured financing should be agreed with all involved parties.

6.6.4 Licensees shall ensure that the restructured transaction is reviewed by the SSB and legal counsel of the Licensee to ensure Shari’a compliance and legal validity.

6.6.5 Restructuring or rescheduling does not entitle an Islamic Bank to upgrade the existing risk classification status of the credits automatically. Such credits shall be upgraded only after satisfactory performance of one year from the date of the first payment of profit or principal, whichever is earlier, under the rescheduled / renegotiated terms.

6.6.6 Restructuring of the facilities should not enhance the maturity of a given Islamic contract leading to a rollover. The restructured contract shall be based on an underlying physical transaction and subject to the approval of the SSB.

6.6.7 Restructuring or rescheduling shall not be used as a means for pre-empting the classification of credits into adverse risk categories. The credit decision to restructuring or rescheduling of credits should be backed by thorough risk appraisal for clearly establishing the paying capacity, duly supported by adequate cash flows of the counterparties under the revised terms. Any restructuring or rescheduling which is not supported by proper credit risk assessments would have to be classified according to the underlying risk profile of the credits. Frequent restructuring or rescheduling of credits which is not backed by rigorous credit risk appraisal should be straightaway classified into high risk category, at least one grade lower than the category prior to restructuring or rescheduling.
6.7 **Responsibility for Classification**

6.7.1 The onus of appropriate and instant risk classification of credits rests with the Licensees. They shall design appropriate credit review mechanism for spotting and classification of problem credits, to recognize deterioration in asset quality well in time throughout the financial year.

6.7.2 Credit accounts above a cut-off point, internally decided by the Licensees, shall be evaluated on a continuous basis. The credits, which are basically retail, shall be classified at monthly intervals. However, all the credits shall be evaluated at least once in every quarter for proper risk classification.

6.7.3 The responsibility for proper risk classification of credits and validation thereof shall be clearly delineated and the framework will ensure that any doubts in credit classification are settled through specified internal channels, within one month from the date on which the account would have been classified, as per the extant norms. Licensees shall lay down well-defined administrative procedures for classification of credits, subject to the condition that a clean break is established between the sanctioning authority, which had approved the credit facility/ies, and the authority which is responsible for confirming the risk classification.

6.7.4 Risk classification of credits shall also be validated by the internal and external auditors of the Licensees.

6.8 **Asset Classification - Counterparty-wise or Facility-wise**

6.8.1 Licensees shall evaluate all exposures of a counterparty, in terms of financials - cash flow, net worth, profitability, liquidity, etc. whose account has been classified in a high risk category. If they anticipate problems in recoveries, given the circumstances and downside risks, the Licensees should proactively classify other exposures as well to recognize the latent risks.

6.9 **Split Classification**

6.9.1 Where a Licensee has already decided to write-off a part of its exposures in certain cases, split classification of a single exposure is allowed on the basis of underlying risks. However, the Licensees should evaluate the downside risks before effecting split classification of single exposures.
6.10 Declassification of Credits

6.10.1 Credits, other than rescheduled or restructured, which are categorized as Special Mention or Substandard or Doubtful or Loss could be upgraded upon realizing in cash, in full, the past due principal and / or profit. Islamic Banks have the discretion to declassify / upgrade such credits. The internal and external auditors should validate the declassification / upgradation. However, the declassification / upgradation of credits by the Licensees are subject to validation and modifications, if necessary, by the Central Bank.

6.11 Income Recognition on NPAs

6.11.1 Profit accrued from impaired assets shall be suspended as and when an account is classified. Recognition of income on credits should be objective and based on the record of recovery.

6.11.2 Income on NPAs shall be recognized only on a cash basis.

6.12 Credit Loss Provision

6.12.1 Licensees shall assess credit risk proactively when they book credits and should seek to protect themselves from potential losses - expected and unexpected.

6.12.2 Licensees shall generally cover the expected losses by creating general credit loss provisions at the front end, while the unexpected losses are covered by capital. However, the probability of defaults by counterparties changes over time, particularly in response to changes in economic conditions. During boom period, the counterparties’ ability to repay tends to increase and as a result credit defaults are likely to fall. The reverse is true in tougher economic conditions. Since provisions are a deduction from income, the cyclicality in provisions may contribute to cyclicality in Licensees’ earnings and capital. The Licensees should place equal weight on the current economic environment and on the possibility of changes in economic conditions in the future.

6.12.3 Licensees are, therefore, encouraged to build capital cushion by retaining more profits earned during periods when provision requirements are low, which could be drawn down when large provisions are required to be made. Thus, Licensees should assess the impact of future macroeconomic conditions on their credit quality and build the necessary reserves in boom periods to provide a cushion
against higher realized losses in economic downturns. In principle, the approach for provisions should be dynamic and forward-looking.

6.13 General Credit Loss Provisions

6.13.1 Licensees should, over a period of time, build adequate expertise in estimating the expected and unexpected losses, with the data on past loss experiences, spanning multiple credit cycles. The general credit loss provisions should ideally be determined on the basis of credit ratings and the associated default probabilities, loss given defaults, rating migrations, current macroeconomic environment and other pertinent indicators.

6.13.2 Licensees shall have general credit loss provisions, at least equivalent to 1% of their credits, categorized as Standard and Special Mention for meeting the latent credit losses. However, considering the heightened risk inherent in personal credits, a minimum general loss provision of 2% of the Standard and Special Mention personal credits shall be created. Licensees are also encouraged to create such provisions in excess of the thresholds.

6.13.3 Licensees, which have their own systems in estimating the expected losses, might be permitted, subject to validation of the models by the Central Bank, to create general credit loss provisions on the basis of historical experiences.

6.13.4 Such provisions contribute towards mitigating pro-cyclicality of earnings, besides improving the financials of Licensees. The general credit loss provision is recognized as an expense in the income account and the Licensees could reckon such provisions as well within the maximum limit of 1.25% of the total risk-weighted assets as Tier 2 capital for BIS capital adequacy purposes.

6.14 Specific Credit Loss Provisions

6.14.1 Once the risk classification of credits has been determined on the basis of specific characteristics, Licensees shall make adequate specific credit loss provisions to cover the realized credit risk. Licensees are required to make adequate specific credit loss provisions on the direct or contingent obligations of their customers. The minimum provisioning levels are indicated below:
6.14.2

<table>
<thead>
<tr>
<th>Classification</th>
<th>Provision</th>
<th>Procedure for provisioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substandard</td>
<td>25%</td>
<td>To be fully provided in cash, without reckoning the value of collaterals.</td>
</tr>
<tr>
<td>Doubtful</td>
<td>50%</td>
<td>25% of the provision is required to be made in cash. The balance 25% of the provision could be covered by recourse to the “determined value” of real estate (lower of 100% of the forced sale value or 50% of the estimated market value, valued by a recognized / reputed estate agent within the last three years and properly and legally mortgaged to the Licensee. In case the valuation report is more than three years old, the value of the real estate is not reckoned for determining the provisions) and shares listed in the Muscat Securities Market (MSM), held as security (50% of the latest market value). If the determined value of these collaterals is not sufficient to cover the balance provision of 25%, the Licensees have to arrange for cash provision for the residual amount.</td>
</tr>
<tr>
<td>Loss</td>
<td>100%</td>
<td>25% of the provision is required to be made in cash. The balance 75% of the provision could be covered by recourse to the “determined value” of real estate (lower of 100% of the forced sale value or 50% of the estimated market value, valued by a recognized / reputed estate agent within the last three years and properly and legally mortgaged to the Licensee. In case the valuation report is more than three years old, the value of the real estate is not reckoned for determining the provisions) and shares listed in the Muscat Securities Market (MSM), held as security (50% of the latest market value). If the determined value of these collaterals is not sufficient to cover the balance provision of 75%, the Licensees have to arrange for cash provision for the residual amount.</td>
</tr>
</tbody>
</table>

6.14.3 In cases of credits that are fully backed by deposits (with proper discharge), commercial pre-payments (margin) or securities issued and / or guaranteed or confirmed receivables from the Government of Oman, guarantees from domestic banks including the branches of foreign banks licensed by the Central Bank and overseas banks with a minimum long-term foreign currency credit rating of ‘A’ from international rating agencies, there is no need to make specific provisions. However, when the value of these collaterals and / or the guarantees does not cover the classified amount fully, Licensees shall make cash provisions for the uncovered amount on the basis of the underlying risk classification of the credits. Licensees should enforce such collaterals and / or guarantees in the event of default of the obligations, expeditiously for enhancing the asset quality. In cases where Licensees take unduly long period in enforcing the collaterals or guarantees, adequate provisions, on the basis of the risk classification, should back such credits.

6.14.4 Given the market conditions and liquidity, it is necessary that a conservative approach be followed in the manner of reckoning the type and value of collaterals. Recognizing the constraints involved in the disposal of
mortgaged properties, susceptibility to market fluctuations and liquidity, Licensees shall assume only conservative periods, based on historical experiences for discounting the cash flows that might arise out of the sale of real estates, under the applicable accounting standard. Further, Licensees shall estimate the provisions independently on a two-track approach i.e. the Central Bank’s norm and under the adopted accounting standard and create provisions on a portfolio-wide basis, subject to the condition that the higher of the provisions will be made determined under either of the methods.

6.15 Acquisition of Real Estate and Personal Property

6.15.1 Licensees are allowed to acquire real estate and personal property in satisfaction of debts previously contracted within the normal course of banking business, subject to the condition that such property is sold or otherwise disposed of within 12 months of the date of acquisition, unless an extension is granted by the Central Bank. Until such property is finally sold or disposed of, Licensees shall not release the specific provisions that backed such credits to the income account.

6.16 Write-off of NPAs

6.16.1 Licensees shall have clearly articulated write-off / waiver policies established by the Board of Directors, delineating the approach, authority, accountability for negligence and inappropriate follow-up, independent review and audit, continuous monitoring, reporting, etc. The policies shall aim at recovering maximum salvage value through enforcement of collateral / guarantees, etc. Licensees should also be extremely prudent in entering into compromise proposals / waiving any part of the claims with the counterparties and guarantors and all such decisions should have the approval of the appropriate authorities.

6.16.2 Licensees should consult their Internal Shari’a Reviewer or SSB for guidance on the NPAs and subsequent write-offs in case of any ambiguity on Shari’a implications.

6.16.3 Further, the decisions to compromise Licensees’ claims should be pursued only when all available remedies including legal actions against the counterparties and guarantors have been fully exhausted. Where the write-off / waiver is considered before exhausting all the recourses, the
justifications shall be clearly established and the cases shall be duly approved by the full Board of Directors.

6.16.4 Where the claims have been written-off only for recognizing the status of asset quality, steps towards recovery of the dues should be pursued vigorously. Licensees should also subject all write-offs / waivers to independent review and internal audit and maintain all the relevant records for ex-post scrutiny of the external auditors / Central Bank.

6.16.5 In the normal course, no proposals for write-off / waiver in respect of claims on senior members and their related parties of any of the licensed financial institutions should be considered. However, in respect of exceptionally genuine cases, the proposals, duly endorsed by the full Board of Directors, should be referred in the format (Annexure 8) to the Central Bank. Only in cases where the Central Bank does not raise any objections within 30 days from the date of reference, Islamic Banks can write-off or enter into agreement with such counterparties and guarantors for waiver or write-off. The details of such cases should also be disclosed in the financial statements.

6.16.6 Licensees shall disclose their policies on waiver of claims / write-offs and the amounts actually waived or written-off, in a particular year, in the respective annual financial statements to ensure greater transparency. Licensees shall also report on a quarterly basis (number of accounts, total amount involved and manner of write-off) the Non Performing Assets waived or written-off, separately along with the Quarterly Monitoring Reports. Further, all write-offs or waivers involving compromises of RO 100,000/- and over shall be reported individually in the format (Attachment 7.9).

6.17 Penalty

6.17.1 A Licensee may charge penalty on facilities where it was set out in the original financing terms and mutually agreed with the counterparty.

6.17.2 Such charges are imposed with the objective to deter the customer from making wilful default.

6.17.3 Recoveries of such charges are donated to the charity fund maintained by the Licensee for this purpose, and do not form part of the Licensees’ income. Disbursement from this fund to eligible charities or charitable causes is made under the supervision of the SSB.
7. Attachments

7.1 Indemnity Agreement

THIS INDEMNITY AGREEMENT is made this ____________ day of _______ 20

BETWEEN

(1) ________________________________

of __________________________________

(hereinafter referred to as the "Indemnifying Bank")

AND

(2) ________________________________

of __________________________________

Sultanate of Oman (hereinafter referred to as the "Beneficiary Bank").

WHEREAS

(A) The Beneficiary Bank has agreed to make available to

of ________________________________ (hereinafter referred to as the "Counterparty")

certain credit facilities (hereinafter referred to as the "Facilities") not exceeding the

sum of Rials Omani _______ RO ________________________________

(hereinafter referred to as the "Principal Amount").

(B) The Principal Amount exceeds the maximum amount of credit facilities which the Beneficiary

Bank is permitted under Omani Banking law to make available to the Counterparty, which

maximum amount is presently Rials Omani _______ RO ________________________________

(hereinafter referred to as the "Permitted Amount") unless collateral, whether in the form of this Indemnity Agreement or otherwise, is obtained in respect of such credit

facilities; and

(C) The Indemnifying Bank has agreed with the Beneficiary Bank to provide collateral and to grant

to the Beneficiary Bank an indemnity in terms of this Indemnity Agreement. This Indemnity

Agreement shall also be binding on any successors of both Indemnifying Bank and the

Beneficiary Bank who shall automatically become parties to this Indemnity Agreement:

IT IS AGREED AS FOLLOWS:

1. The Indemnifying Bank shall, on a continuing basis, indemnify and keep indemnified the

Beneficiary Bank against the following:-

   i) all demands, claims, losses, costs and expenses whatsoever in excess of the

      Permitted amount (including all legal and other costs, charges and expenses) that the

      Beneficiary Bank may incur as a result of having made the Facilities available;

   ii) all demands, claims, losses, costs and expenses whatsoever (including all legal and

       other costs, charges and expenses) the Beneficiary Bank may incur in enforcing its

       rights in terms of this Indemnity Agreement;

   iii) any documentation relating to the Facility being or becoming void, voidable, invalid or

       unenforceable; or

   iv) any failure of the Counterparty fully and promptly to perform any or all of its

       obligations to the Beneficiary Bank in relation to the Facilities.
2. For the purposes of this Indemnity Agreement, the Beneficiary Bank shall be deemed to have incurred an indemnified loss or cost upon failure by the Counterparty to pay or repay any parts of the Facilities to the Beneficiary Bank as and when due in accordance with the terms and conditions upon which the Facilities have been made available. The Indemnifying Bank shall pay and reimburse such sums to the Beneficiary Bank on its first written demand together with profit thereon (as well after as before judgment) from the date when they were first due to be paid or repaid to the Beneficiary Bank until payment by the Indemnifying Bank in full at the profit rate of (%) per year above the cost to the Beneficiary Bank (as conclusively determined by it) of acquiring necessary funds in such currency and manner as it may from time to time decide. All such profit shall accrue on a day-to-day basis and be calculated by the Beneficiary Bank on the basis of a 360-day year and profit shall be compounded in accordance with the usual practice of the Beneficiary Bank. The Beneficiary Bank is hereby irrevocably authorized, without prejudice to any right or remedy, to debit such payment or reimbursement to any account that the Indemnifying Bank may have with the Beneficiary Bank.

3. The Indemnifying Bank acknowledges and agrees that this Indemnity is and at all times shall be a continuing security and shall extend to cover the ultimate balance due at any time from the Counterparty to the Beneficiary Bank in excess of the Permitted Amount.

4. The Beneficiary Bank shall not be obliged before taking steps to enforce any of its rights or remedies under this Indemnity (i) to take action or to obtain judgment in any court against any person; (ii) to make or file any claim in a bankruptcy or liquidation of, or to participate in any composition arrangement affecting, any person; or (iii) to demand, enforce or seek to enforce any claim, right or remedy against any person.

5. If any judgment or order is given or made for the payment of any amount due under this Indemnity Agreement and is expressed in a currency other than that in which such amount is payable under this Indemnity Agreement, the Indemnifying Bank shall indemnify the Beneficiary Bank against any loss incurred by it as a result of any variation having occurred in rates of exchange between the date as of which such amount is converted into such other currency for the purpose of such judgment or order and the date of actual payment. The indemnity given in terms of this Indemnity Agreement shall constitute a separate and independent obligation on the part of the Indemnifying Bank and shall continue in full force and effect notwithstanding any such judgment or order.

6. The Indemnifying Bank acknowledges and agrees that none of its liabilities under this Indemnity shall be reduced, discharged or otherwise adversely affected by:

   i) any variation, extension, discharge, compromise, dealing with, exchange or renewal of any right or remedy which the Beneficiary Bank may now or hereafter have from or against the Counterparty or any other person in respect of any of the obligations and liabilities arising in connection with the Facilities;

   ii) any act or omission by the Beneficiary Bank or any other person in taking up, perfecting or enforcing any security, indemnity or guarantee from or against any person;

   iii) any termination, amendment, variation, novation or supplement of or to the terms on which the Facilities are made available;

   iv) any grant of time, waiver, indulgence or concession to the Counterparty or to any other person;

   v) the bankruptcy, insolvency, liquidation, administration, winding-up, reconstruction or merger of the Counterparty or any other person;

   vi) any invalidity, illegality, unenforceability, irregularity or frustration of any obligation of the Counterparty or any other person;

   vii) any act or omission which would have discharged or affected the liability of the Indemnifying Bank had it been a principal debtor instead of indemnitor.
7. The Indemnifying Bank warrants and confirms to the Beneficiary Bank that it has not taken or received, and agrees not to take, exercise or receive the benefit of any security or other right or benefit from or against the Counterparty or any other person in respect of any liability under this Indemnity. If any such right or benefit is taken, exercised or received, the Indemnifying Bank declares that such right or benefit shall be held on trust or as agent for the Beneficiary Bank for application towards the discharge of the liabilities arising in terms of this Indemnity Agreement.

8. All payments to be made under this Indemnity Agreement shall be paid in full without set off or counterclaim and shall be paid free and clear of and without any withholding or reduction for or on account of any taxes, levies, duties or fees or any nature. If either party is compelled by law to make such withholding or deduction such party will ensure that such withholding or deduction will not exceed the minimum required by law and will in addition pay to the other party such additional amounts as may be required in order to ensure that the receiving party receives the full amount which would have been paid to it if no such withholding or deduction had been required.

9. The indemnity granted to the Beneficiary Bank in terms of this Indemnity Agreement shall be in addition to and shall not in any way be prejudiced or affected by any one or more other indemnities, guarantees, securities or other obligations which the Beneficiary Bank may now or subsequently hold whether from the Indemnifying Bank or from any other person.

10. The Beneficiary Bank may place to the credit of a suspense account any monies received under or in connection with this Indemnity in order to preserve the rights of the Beneficiary Bank to prove for the full amount of all of its claims against the Counterparty or any other person. The Beneficiary Bank may, at any time, apply any of such monies in or towards satisfaction of any of the obligations and liabilities the subject of this Indemnity Agreement as the Beneficiary Bank, in its absolute discretion, may from time to time conclusively determine.

11. The Beneficiary Bank shall be at liberty but shall not be bound to resort for its own benefit to any other means of payment at any time and in order it thinks fit without in consequence diminishing the Indemnifying Bank's liability hereunder and the Beneficiary Bank may enforce its rights hereunder either for the payment of the ultimate balance after resorting to other means of payment or for the balance due at any time notwithstanding that other means of payment have not been resorted to and in the latter case without entitling the Indemnifying Bank to any benefit from such other means of payment so long as money remains due or owing or payable (whether actually or contingently) from or by the Indemnifying Bank to the Beneficiary Bank.

12. The Indemnifying Bank shall have no right to direct the application by the Beneficiary Bank, of any sums received by the Beneficiary Bank from the Indemnifying Bank under, or pursuant to, any of the terms of this Indemnity Agreement.

13. Any release, discharge or settlement between the Indemnifying Bank and the Beneficiary Bank in relation to this Indemnity Agreement shall be conditional upon no right, security, disposition or payment to the Beneficiary Bank by any of the Indemnifying Bank or any other person being void, set aside or ordered to be refunded for any reason. If any such right, security, disposition or payment is void or at any time so set aside or ordered to be refunded, the Beneficiary Bank shall be entitled subsequently to enforce this Indemnity against the Indemnifying Bank as if such release, discharge or settlement had not occurred and any such security, disposition or payment had not been made.

14. Any demand, notification or certificate given by the Beneficiary Bank specifying amounts due and payable under or in connection with any of the provisions of this Indemnity Agreement shall, in the absence of manifest error, be conclusive and binding on the Indemnifying Bank.

15. The Beneficiary Bank may, without notice to the Indemnifying Bank, apply any credit balance which is at any time held by any office or branch of the Beneficiary Bank for the account of the Indemnifying Bank in or towards satisfaction of any sum then due and payable from the Indemnifying Bank under this Indemnity Agreement. The Beneficiary Bank may convert or translate all or any part of such credit balance into another currency applying a rate which in the Beneficiary Bank's opinion fairly reflects the relative prevailing rates of exchange.
16. The Beneficiary Bank's rights under this Indemnity Agreement are cumulative and not exclusive of any rights provided by law and may be exercised from time to time and often as the Beneficiary Bank deems expedient.

17. Any waiver by the Beneficiary Bank of any of the terms of this Indemnity Agreement, or any consent or approval given by the Beneficiary Bank under it, shall only be effective if given in writing and then only for the purpose and upon the terms and conditions, if any, on which it is given.

18. If at any time any one or more of the provisions of this Indemnity Agreement is or becomes illegal, invalid or unenforceable in any respect under any law of any jurisdiction, neither the legality, validity and enforceability of the remaining provisions of this Indemnity Agreement nor the legality, validity or enforceability of such provision under the law of any other jurisdiction shall be in any way affected and impaired as a result.

19. The Indemnifying Bank hereby represents and warrants to the Beneficiary bank that:
   a) the Indemnifying Bank is duly incorporated and is a validly existing company under the laws of its place of incorporation, has the capacity to sue or be sued in its own name and, has power to carry on its business as now being conducted and to own its property and other assets;
   b) the Indemnifying Bank has full power and authority to execute, deliver and perform its obligations under this Indemnity Agreement and no limitation on the powers of the Indemnifying Bank will be exceeded as a result of the Indemnifying Bank entering into this Indemnity Agreement.
   c) the execution, delivery and performance by the Indemnifying Bank of this Indemnity Agreement and the performance of its obligations under this Indemnity Agreement have been duly authorized by all necessary corporate action and do not contravene or conflict with:
      1) the Indemnifying Bank's memorandum and articles of association or other equivalent constitutional documents; or
      2) any existing law, statute, rule or regulation or any judgment, decree or permit to which the Indemnifying Bank is subject; or
      3) the terms of any agreement or other document to which the Indemnifying Bank is a party or which is binding upon it or any of its assets; and
   d) This Indemnity Agreement is the legal, valid and binding obligation of the Indemnifying Bank and is enforceable against the Indemnifying Bank in accordance with its terms. The Indemnifying Bank acknowledges that the Beneficiary bank has accepted this Indemnity in full reliance on the representations and warranties set out in this clause.

The Indemnifying Bank acknowledges that the Beneficiary bank has accepted this Indemnity in full reliance on the representations and warranties set out in this clause.

20. Any notice, demand or communication to be given under this Indemnity Agreement shall be in writing and shall be deemed to be duly served if in the English language and sent by courier, telex or fax received at:
   i) In respect of the Indemnifying Bank:

      [ ]

      [ ]

      Telex no.: [ ]
ii) In respect of the Beneficiary Bank:-

[ ]

[ ]

Telex no.: [ ]

Fax no.[ ]

21. Within 5 (five) days of the execution of this Indemnity Agreement by the parties hereto, the Beneficiary Bank shall send details of this Indemnity Agreement to the Central Bank of Oman in the form of the table set out in Annexure 4.

22. The Indemnifying Bank irrevocably agrees that the Central Bank of Oman shall have the right to enforce this Indemnity Agreement in accordance with its terms as if the Central Bank of Oman was the Beneficiary Bank under this Indemnity Agreement.

23. 
   a) This Indemnity Agreement is governed by and shall be construed in accordance with Omani law.
   b) The Indemnifying Bank irrevocably agrees for the exclusive benefit of the Beneficiary Bank that the Commercial Court of Oman or any successor body thereto shall have jurisdiction to hear and determine any suit, action or proceeding, and to settle any dispute, which may arise out of or in connection with this Indemnity Agreement and for such purposes hereby irrevocably submits to the jurisdiction of such court.
   c) Nothing contained in this clause 23 shall limit the right of the Beneficiary Bank to take proceedings against the Indemnifying Bank in any other court of competent jurisdiction, nor shall the taking of any such proceedings in one or more jurisdictions preclude the taking of proceedings in any other jurisdiction, whether concurrently or not (unless precluded by applicable law).
   d) The Indemnifying Bank irrevocably waives any objection which it may have now or in the future to the Commercial Court of Oman being nominated, whether on the ground of venue or otherwise, and agrees not to claim that any such court is not a convenient or appropriate forum.

IN WITNESS WHEREOF this Indemnity Agreement has been duly executed by the parties on the day and year first above written.

SIGNED for and on behalf of )

by )
in the presence of )

SIGNED for and on behalf of )

by )
in the presence of )
7.2 Statement Showing the List of Connected Counterparties with Credit Exposure in Excess of 10% of Bank’s Capital

<table>
<thead>
<tr>
<th>Name of the Bank</th>
<th>Position as at the end of March/June/September/December 200X</th>
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</thead>
<tbody>
<tr>
<td>Total Capital, as approved by the Central Bank:</td>
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<tr>
<td>Connected party limit @15% of bank’s total capital</td>
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</tbody>
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<thead>
<tr>
<th>S.No.</th>
<th>Name of the principal connected party</th>
<th>Name of the connected parties, related to the principal connected party</th>
<th>Relationship with the principal connected party</th>
<th>NID/CR No</th>
<th>Type of Facility</th>
<th>Date of Original Sanction</th>
<th>Date of Last Renewal</th>
<th>Final Repayment Date</th>
<th>Limit Sanctioned</th>
<th>Amount Outstanding</th>
<th>Maximum Exposure during the reporting period</th>
<th>Excess, over the financing limitation</th>
<th>Collateral Acceptable under Banking Law</th>
<th>Reason/explanation for the excess &amp; other remarks</th>
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<th>Sl. No.</th>
<th>Name</th>
<th>Description</th>
<th>Value</th>
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<td>Section 1 (Exposures exceeding 15% of total capital)</td>
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<th>Section 2 (Exposures exceeding 15% of total capital)</th>
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<td>Sub Total</td>
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<th>Section 3 (Exposures exceeding 15% of total capital)</th>
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<td>Sub Total</td>
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Title 6 – Credit Risk  Page 70
### Section - 8 (Exposures exceeding 10% but less than 15% of total capital)

<table>
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<tr>
<th>S.No.</th>
<th>Name of the principal connected party</th>
<th>Name of the connected parties, related to the principal connected party</th>
<th>Relationship/connection with the principal connected party</th>
<th>NHO/CRNo</th>
<th>Type of Facility</th>
<th>Date of Original Sanction</th>
<th>Date of Last Renewal</th>
<th>Final Repayment Date</th>
<th>Sanctioned</th>
<th>Outstanding</th>
<th>Maximum Exposure during the reporting period</th>
<th>Collateral Acceptable under Banking Law</th>
<th>Remarks</th>
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<td>SI. No. Name</td>
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**Guidance for compiling the return**

1. The Section on Credit Risk may be used for the definitions of connected counter parties, large exposures, collaterals, etc.
2. The report may be provided in two sections, the first section containing cases where the 15% connected party limit has been exceeded with reasons, etc.
3. The second section may contain all other exposures where the total exposure is above 10% but less than 15% of total capital.
4. Maximum Exposure Column should be the maximum exposure to the counter party during the last quarter.
5. Reasons/explanation for excess could be Govt. project, nationally important project, SAOG company, Bank indemnity, cash collateral, etc. which along with any other associated remarks could be provided under the 'remarks' column.
### Statement Showing the List of Senior Members / Related Parties with Credit Exposure in Excess of 10% of Bank’s Capital

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Name of the principal Senior Member/related party</th>
<th>Name of the related parties, related to the principal Senior Member/related party</th>
<th>Relationship/Connection with the principal</th>
<th>NID/CR No</th>
<th>Type of Facility</th>
<th>Final Repayment Date</th>
<th>Date of Original Sanction</th>
<th>Date of Last Renewal</th>
<th>Limit Sanctioned</th>
<th>Profit Rate</th>
<th>Amount Outstanding</th>
<th>Maximum Exposure during the reporting period</th>
<th>Excess, over the financing limitation</th>
<th>Collateral Acceptable under Banking Law</th>
<th>Reason/ explanation for the excess &amp; other remarks</th>
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**Total Capital, as approved by the Central Bank:**

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<tr>
<th>Description</th>
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<th>Sl. No.</th>
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<th>SI. No.</th>
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<th>Subtotal</th>
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</table>

Title 6 – Credit Risk Page 72
Guidance for compiling the return

1. The Section on Credit Risk may be used for the definitions of connected counter parties, large exposures, collaterals, etc.

2. Amount outstanding Column and Maximum exposure Column should be the gross exposure before applying any collateral

3. Maximum Exposure Column should be the maximum exposure to the counter party during the last quarter.

4. Reasons/explanation for excess could be Govt. project, nationally important project, SAOG company, Bank indemnity, cash collateral, etc. which along with any other associated remarks could be provided under the ‘remarks column.'
# Statement of Indemnity Agreements / Guarantees / Warranties

<table>
<thead>
<tr>
<th>Name of the Bank:</th>
<th>Position as at the end of March/June/September/December 200X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Capital, as approved by the Central Bank:</td>
<td></td>
</tr>
<tr>
<td>25% of the total capital:</td>
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</table>

<table>
<thead>
<tr>
<th>SI No</th>
<th>Name of the Beneficiary Bank</th>
<th>Name of the Counterparty, on whose behalf issued</th>
<th>NID/CIR Number of the Counterparty</th>
<th>Amount Indemnified</th>
<th>Valid upto</th>
<th>Other Credit exposure if any to the Counterparty by your Bank</th>
<th>Collateral available as security against the facilities granted to Counterparty by your bank</th>
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<td>Amount Indemnified</td>
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<td>Other Credit exposure if any to the Counterparty by your Bank</td>
<td>Collateral available as security against the facilities granted to Counterparty by your bank</td>
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**Guidance for compiling the return**

1. The Section on Credit Risk may be used for the definitions of connected counter parties, large exposures, collaterals, etc.
2. Details of indemnities etc. issued by the bank in favour of counter parties need to be provided beneficiary 'bank-wise'. That is all the indemnities, etc. issued from a particular indemnifying bank has to be listed together, then similar listing for another bank given and so on.
3. Only those indemnity agreements/guarantees or warranties received for covering the excesses over financing limits are to be reported here.
### Statement of Indemnity Agreements / Guarantees / Warranties received by Licensed Banks from Banks within and outside the Sultanate of Oman

#### Name of the Bank:  
Position as at the end of March/June/September/December 200X

**Total Capital, as approved by the Central Bank:**

**25% of the total capital:**

<table>
<thead>
<tr>
<th>SI No</th>
<th>Name of the Indemnity issuing Bank</th>
<th>Name of the Counterparty, on whose behalf issued</th>
<th>NID/CIR Number of the Counterparty</th>
<th>Amount Indemnified</th>
<th>Valid upto</th>
<th>Other Credit exposure, if any, to the Counterparty by your Bank</th>
<th>Collateral available as security against the facilities granted to Counterparty</th>
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<tr>
<th>SI No</th>
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**sub-total**

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</table>

**Grand Total**

**Authorised Signatories**

**Date**

**Guidance for compiling the return**

1. The Section on Credit Risk may be used for the definitions of connected counter parties, large exposures, collaterals, etc.
2. Details of indemnities etc. received by the bank in favour of counterparties need to be provided indemnity-issuing 'bank-wise'. That is all the indemnities, etc. issued from a particular indemnifying bank has to be listed together, then similar listing for another bank given and so on.
3. Only those indemnity agreements/ guarantees or warranties received for covering the excesses over financing limits are to be included here.
7.5 Report on Credit Facilities in Foreign Currency to Non-Residents for Operations Abroad

For the Quarter ended ……..

Bank Name: 

<table>
<thead>
<tr>
<th>Sr No</th>
<th>Name &amp; Nationality</th>
<th>Country of Operation</th>
<th>Country Risk Classification *</th>
<th>Risk Type</th>
<th>Validity Period</th>
<th>Foreign Currency &amp; Amount</th>
<th>Equivalent in RO</th>
<th>Foreign Currency &amp; Amount</th>
<th>Equivalent in RO</th>
<th>% to Domestic Net Worth</th>
<th>Risk Classification **</th>
<th>Provisions General</th>
<th>Reserve Profit Specific</th>
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</thead>
<tbody>
<tr>
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</table>

Latest Domestic Net Worth (LNW) as approved by the Central Bank of Oman = RO.

* Country Risk classification of country of operation, as per OECD Country Ratings (www.oecd.org - Trade Directorate - External Credit Arrangement web page)

** Risk classification - Standard, Special Mention, Sub-standard, Doubtful or Loss
7.6 Report on Syndicated Financing

For the Quarter ended ………

<table>
<thead>
<tr>
<th>Bank Name:</th>
<th>Amount 000’s</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Counterparty Details**</th>
<th>Outstanding Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sr No</td>
<td>Name of the Counterpart</td>
</tr>
<tr>
<td>-------</td>
<td>----------------------</td>
</tr>
<tr>
<td>Section I - Resident Counterparties</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td></td>
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<td>2</td>
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<tr>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Sub-total</td>
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</tbody>
</table>

| Section II - Non Resident Counterparties |
| 1 | | | | | | | | | | | | |
| 2 | | | | | | | | | | | | |
| 3 | | | | | | | | | | | | |
| 4 | | | | | | | | | | | | |
| Sub-total | | | | | | | | | | | | |

| Grand Total | | | | | | | | | | | | |

* Risk classification - Standard, Special Mention, Sub-standard, Doubtful or Loss
** Details are to be reported Syndication-wise
7.7 Report on Placement of Banks’ Funds Abroad

For the Month ended ……………………………

Bank Name:  

<table>
<thead>
<tr>
<th>SL No</th>
<th>Details</th>
<th>Foreign Currency &amp; Amount</th>
<th>Equivalent in RO</th>
<th>% to Domestic Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
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</tbody>
</table>

Section - A - Applicable only for Domestic Banks

I Principal Shareholders / Own Offices / Branches Abroad

a 

b 

c 

Sub-total

II Affiliate of Principal Shareholders Abroad

a 

b 

c 

Sub-total

III Branches of Domestic Banks Abroad

a 

b 

c 

Sub-total

Grand total

Section- B - Applicable only for Foreign Banks

I Head Office and Own Branches Abroad

a Head Office 

b Own Branches Abroad 

Sub-total

II Head Office Affiliate Abroad

a 

b 

c 

Sub-total

Grand total

Latest Domestic Net Worth (LNW) as approved by the Central Bank = RO.
### 7.8 Proposal for Waiver / Write-off of Non-Performing Assets in Respect of Claims on Senior Members and their Related Parties

<p>| | |</p>
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<tbody>
<tr>
<td>1</td>
<td>Name of the Bank</td>
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<tr>
<td>2</td>
<td>Name of the Counterparty/ies</td>
</tr>
<tr>
<td>3</td>
<td>Relationship with the Bank</td>
</tr>
<tr>
<td>4</td>
<td>Legal Status of the Counterparty/ies</td>
</tr>
<tr>
<td>5</td>
<td>ID No. or CR No. or Passport No. &amp; Issue Date (as applicable)</td>
</tr>
<tr>
<td>6</td>
<td>Name of the Guarantor/s, if any</td>
</tr>
<tr>
<td>7</td>
<td>Legal Status of the Guarantor/s</td>
</tr>
<tr>
<td>8</td>
<td>ID No. or CR No. or Passport No. &amp; Issue Date (as applicable)</td>
</tr>
<tr>
<td>9</td>
<td>Date of Original Sanction</td>
</tr>
<tr>
<td>10</td>
<td>Date of Latest Renewal / Review</td>
</tr>
<tr>
<td>11</td>
<td>Balance Outstanding</td>
</tr>
<tr>
<td>12</td>
<td>Current Classification Status</td>
</tr>
<tr>
<td>13</td>
<td>Date of placing the accounts on non-accrual basis</td>
</tr>
<tr>
<td>14</td>
<td>Amount to be waived / written-off</td>
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<tr>
<td>15</td>
<td>Reserve Profit</td>
</tr>
<tr>
<td>16</td>
<td>Provisions</td>
</tr>
<tr>
<td>17</td>
<td>Amount to be met from Current Year's Profit</td>
</tr>
<tr>
<td>18</td>
<td>Details of Collaterals:</td>
</tr>
<tr>
<td></td>
<td>a) Cash Collaterals</td>
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<tr>
<td></td>
<td>b) Real Estate</td>
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<td></td>
<td>• Forced Sale Value</td>
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<td>• Market Value</td>
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<tr>
<td></td>
<td>c) MSM Securities – Market Value</td>
</tr>
<tr>
<td></td>
<td>d) Others (please specify)</td>
</tr>
<tr>
<td>19</td>
<td>Latest financial position of the Counterparty/s</td>
</tr>
<tr>
<td>20</td>
<td>Latest financial position of the Guarantor/s</td>
</tr>
<tr>
<td>21</td>
<td>Steps taken by the bank in recovering the</td>
</tr>
<tr>
<td>22</td>
<td>Reason/s for waiver / write-off</td>
</tr>
<tr>
<td>23</td>
<td>Authority approving the waiver / write-off</td>
</tr>
<tr>
<td>24</td>
<td>Summary of the proposed agreements with the counterparties / guarantors</td>
</tr>
</tbody>
</table>

Authorized Signatory ___________________________  Date: ___________________________
### Reporting of Waiver / Write-off of Non-Performing Assets with a Compromise of RO 100,000 and Above

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<td>1.</td>
<td>Name of the Bank</td>
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<td>2.</td>
<td>Name of the Counterparty/s</td>
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<td>3.</td>
<td>Relationship with the Bank</td>
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<td>Legal Status of the Counterparty/s</td>
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<tr>
<td>5.</td>
<td>ID No. or CR No. or Passport No. &amp; Issue Date (as applicable)</td>
</tr>
<tr>
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<td>Name of the Guarantor/s, if any</td>
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<tr>
<td>7.</td>
<td>Legal Status of the Guarantor/s</td>
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<td>ID No. or CR No. or Passport No. &amp; Issue Date (as applicable)</td>
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<td>9.</td>
<td>Date of Original Sanction</td>
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<td>10.</td>
<td>Date of Latest Renewal / Review</td>
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<td>11.</td>
<td>Balance Outstanding</td>
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<tr>
<td>12.</td>
<td>Classification Status at the time of waiver / write-off</td>
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<tr>
<td>13.</td>
<td>Date of placing the accounts on non-accrual basis</td>
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<tr>
<td>14.</td>
<td>Amount to be waived / written -off</td>
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<td>a) From Reserve Profit</td>
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<tr>
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<td>b) From Provisions</td>
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<td></td>
<td>c) From Current Year’s Profit</td>
</tr>
<tr>
<td>15.</td>
<td>Details of Collaterals:</td>
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<td>a) Cash Collaterals</td>
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<td>• Forced Sale Value</td>
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<td></td>
<td>• Market Value</td>
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<tr>
<td></td>
<td>c) MSM Securities – Market Value</td>
</tr>
<tr>
<td></td>
<td>d) Others (please specify)</td>
</tr>
<tr>
<td>16.</td>
<td>Latest financial position of the Counterparty/s</td>
</tr>
<tr>
<td>17.</td>
<td>Latest financial position of the Guarantor/s</td>
</tr>
<tr>
<td>18.</td>
<td>Steps taken by the bank in recovering the dues</td>
</tr>
<tr>
<td>19.</td>
<td>Justifications for waiver / write-off</td>
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<tr>
<td>20.</td>
<td>Authority approving the waiver / write-off</td>
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Authorized Signatory | Date:
1 BM 1093
2 BM 1094
TITLE 7: MARKET RISK

Islamic Banking Regulatory Framework
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1. Market Risk Management

1.1 General

1.1.1 Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leasable assets (including Sukuk) and in off-balance sheet individual portfolios (for example restricted investment accounts). The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a Sukuk, the market value of Murabaha assets purchased to be delivered over a specific period) and of foreign exchange rates.

1.1.2 Licensees may hold position in assets that are actively traded. The value of the assets is exposed to commodity price change due to various market factors. Similarly when the Licensees are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to changes in liquidity of the markets in which the assets are traded and which give rise to greater market risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets.

1.1.3 Licensees may also be exposed to market risk in traditional financing products. For example, in an Ijarah Muntahia Bittamleek (IMB) where the asset is available for lease and the Licensee has no binding Promise to Lease from a customer, the Licensee is exposed to market risk until the lessee takes position. However, upon consigning the lease, the market risk no longer exists. The Licensee is exposed to traditional credit risk.

1.1.4 Traditionally, credit risk management has been the primary challenge for banks. With liberalization and growing integration of global financial markets, risk arising from adverse changes in market variables, such as rate of return, foreign exchange rate, equity price and commodity price has become relatively more important. Even a small change in market variables may cause substantial changes in income and economic value of the Licensees.

1.2 Operational Considerations

1.2.1 Licensees shall introduce effective risk management systems that address the issues related to rate of return, foreign exchange, equity and commodity price risks.

1.2.2 Licensees shall address these risks in a structured manner by upgrading their risk management policies, practices and procedures and adopting more comprehensive Asset-Liability Management (ALM) practices.
1.2.3 ALM, among other functions, is concerned with risk management and provides a comprehensive and dynamic framework for measuring and monitoring foreign exchange, commodity price, rate of return and equity price risks along with liquidity risks. It involves assessment of various types of risks and altering the asset-liability profile in a dynamic way to manage risks.

1.2.4 The management of market risk should be the major concern of the Board of Directors of the Licensee. The Board shall clearly articulate market risk management policies, procedures, prudential risk limits, review mechanisms and reporting and auditing systems. The policies should address the Licensees’ exposure on a consolidated basis, clearly articulate the risk measurement systems that capture all material sources of market risk and assess the effects on the Licensees. The operating prudential limits and the accountability of the line management should also be clearly defined.

1.2.5 Licensees shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, funded and non-funded, including those that do not have a ready market and/or are exposed to high price volatility.

1.2.6 Licensees shall develop a market risk strategy including the level of acceptable market risk appetite taking into account contractual agreements with fund providers, types of risk-taking activities and target markets in order to maximise returns while keeping exposures at or below the pre-determined levels. The strategy should be reviewed periodically by the Licensees, communicated to relevant staff and disclosed to fund providers.

1.2.7 Licensees shall establish a sound and comprehensive market risk management process and information system, which (among others) shall comprise of the following:

1.2.7.1 a conceptual framework to assist in identifying underlying market risks;

1.2.7.2 guidelines governing risk taking activities in different portfolios of restricted Investment Account Holders (IAHs) and their market risk limits;

1.2.7.3 appropriate frameworks for pricing, valuation and income recognition; and

1.2.7.4 a strong MIS for controlling, monitoring and reporting market risk exposure and performance to appropriate levels of senior management.

1.2.8 Given that all the required measures are in place (e.g. pricing, valuation and income recognition frameworks, strong MIS for managing exposures, etc.) the applicability of
any market risk management framework that has been developed should be assessed taking into account consequential business risks.

1.2.9 Licensees should be able to quantify market risk exposures and assess exposure to the probability of future losses in their net open asset positions. Licensees should take care to minimise risk with the open positions subject to Shari’a compliant methods.

1.2.10 Licensees shall ensure that their market risk strategy includes the definition of their risk appetite for these tradable assets and that this risk appetite is adequately supported by capital held for that purpose.

1.2.11 Licensees shall establish policies / documentation with respect to sources of market prices and how the market prices for various assets are to be obtained. In the valuation of assets where no direct market prices are available, Licensees shall incorporate in their own product programme a detailed approach to valuing their market risk positions. Licensees may employ appropriate forecasting techniques to assess the potential value of these assets.

1.2.12 Where available valuation methodologies are deficient, Licensee shall assess the need (a) to allocate funds to cover risks resulting from illiquidity, new assets and uncertainty in assumptions underlying valuation and realisation; and (b) to establish a contractual agreement with the counterparty specifying the methods to be used in valuing the assets.

1.2.13 Licensees have a fiduciary duty to apply the same risk management policies and procedures to assets held on behalf of restricted IAH as they do for assets held on behalf of shareholders and unrestricted IAH.

1.2.14 Where Licensees play the role of market maker to restricted IAH, this gives rise to liquidity risk, which should be managed.

1.2.15 In addition to managing the balance sheet, the Asset-Liability Management Committee (ALCO), consisting of the Licensee’s senior management including CEO must also articulate the Licensee’s view on various market variables and base its decisions for future business strategy.

1.2.16 The Licensees shall also set up an independent Middle Office to track the magnitude of market risk on a real time basis. The Middle Office should comprise of experts in market risk management, economists, statisticians and general bankers and may be functionally placed directly under the ALCO. The Middle Office should also be separated from the Treasury Department and should not be involved in the day-to-day management of the Treasury. The Middle Office should apprise the senior management / ALCO / Treasury about
adherence to prudential / risk parameters and also aggregate the total market risk exposures assumed by the Licensee at any point of time.

1.2.17 Licensees shall make sure that the functions of various departments are defined in such a way that there are no overlapping functions and that there is no conflict of interest.
2. Commodity Price Risk

2.1 Introduction

2.1.1 This Article sets out principles in respect of commodity price risk, which refers to the potential impact of adverse price movements of commodity prices on the economic value of an asset. Commodity price risk exposures may occur at certain times or throughout the contract.

2.1.2 Commodity price risk is defined as the risk of losses in on- or off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable or marketable commodities. The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset or the market value of Murabaha assets purchased to be delivered over a specific period).

2.1.3 In operating Ijarah, a lessor is exposed to commodity price risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract. In Ijarah Muntahiya Bit'tamli'ek (IMB), a lessor is exposed to market risk on the carrying value of the leased asset (as collateral) in the event that the lessee defaults on the lease obligations.

2.1.4 In Salam, Licensees are exposed to commodity price fluctuations on a long position after entering into a contract and while holding the subject matter until it is disposed of. In the case of Parallel Salam, there is also the risk that the failure of delivery of the subject matter would leave the Licensee exposed to commodity price risk as a result of the need to purchase a similar asset from the spot market in order to honour the Parallel Salam contract.

2.1.5 In a non-binding Murabaha for the purchase orderer, if a customer decided to cancel the contract to purchase, the Licensee may have no alternative other than to sell the commodity in the open market at a selling price that may be lower than the purchase price. The Licensee may have to devote resources for marketing efforts in order to sell the said commodity, or have to dispose of the asset at a loss. Alternatively, the Licensee may have to hold the commodity and incur additional costs, such as warehousing, insurance or even damages (if the commodity is perishable in nature).

2.1.6 In I'tisna’ with Parallel I’tisna’, if the customer under a direct I’tisna’ defaults in fulfilling the terms of the contract and the Licensee has to find another purchaser for the asset, it may be exposed to price risk if the new purchaser can be found only for a price lower than the original contract price.

2.1.7 When the Licensees are involved in buying assets that are not actively traded with the intention of selling them, it is important to analyse and assess the factors attributable to
changes in liquidity of the markets in which the assets are traded and which give rise to greater commodity price risk. Assets traded in illiquid markets may not be realisable at prices quoted in other more active markets.

2.2 **Operational Considerations**

2.2.1 While conducting transactions in different commodities and markets, a Licensee should highlight the specific market risk factors corresponding to each commodity and market, and specify how it manages those risks.

2.2.2 A Licensee should also underline its limits on exposures set by the management or supervisory authorities, if any, in those commodities and markets, and its systems should include regular independent reviews of risk management (especially to capture specific commodity price risk) – for example, in its internal auditing process.

2.2.3 Licensees should be able to quantify commodity risk exposures and assess exposure to the probability of future losses in their net open positions.

2.2.4 In the valuation of commodities where no direct market prices are available, Licensees shall incorporate in their own product programme a detailed approach to valuing their market risk positions arising from fluctuations in commodity prices. Licensees may employ appropriate forecasting techniques to assess the potential value of these commodities.

2.2.5 Where available valuation methodologies are deficient, Licensees shall assess the need (a) to allocate funds to cover risks resulting from illiquidity, new commodities and uncertainty in assumptions underlying valuation and realisation; and (b) to establish a contractual agreement with the counterparty specifying the methods to be used in valuing the commodity positions.
3. Foreign Exchange (Forex) Risk

3.1 Introduction

3.1.1 *The risk inherent in running open foreign exchange positions has heightened in recent years by the pronounced volatility in forex rates, thereby adding a new dimension to the risk profile of banks’ balance sheets.*

3.1.2 *Licensees are exposed to foreign exchange fluctuations arising from general FX spot rate changes in both cross-border transactions and the resultant foreign currency receivables and payables. Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position in an individual foreign currency.*

3.1.3 *In the forex business, Licensees also face the risk of default of the counterparties or settlement risk. While such type of risk crystallization may not necessarily cause principal loss, Licensees may have to undertake fresh transactions in the cash/spot market for replacing the failed transactions. Thus, Licensees may incur replacement cost, which depends upon the currency rate movements.*

3.2 Forex Risk Management Measures

3.2.1 Licensees are also exposed to foreign exchange fluctuations arising from general FX spot rate changes in their foreign currency receivables and payables. Licensees shall hedge these exposures to the extent possible using Shari’a compliant methods.

3.2.2 Forex risk shall be mitigated through fixing appropriate limits on open positions and gaps. The open position in all currencies shall be pegged at 40% of the capital and reserves of the Licensees. Licensees may, however, fix appropriate limits (even less than the limits set by the Central Bank) depending upon the capital position, overall risk profile and risk management capabilities.

3.2.3 The Central Bank has not fixed any limits on gaps. All Licensees shall, however, fix appropriate limits on individual and aggregate gaps, linked to capital to prudently manage the forex risk exposures. The top management could also adopt the Value at Risk (VaR) approach to measure the risk associated with exposures.

3.2.4 The statement of Forex Position (FXP), Maturity of Assets and Liabilities (MAL) could be used for measurement and periodical monitoring of forex risk
exposures. Licensees should also ensure clear-cut and well-defined division of responsibility between front, middle and back offices.

3.2.5 *Analysis of forex risk exposure involves tracking of cash flow mismatches in each currency with material exposure. The cash flow profile of the Licensees could be analysed on a static basis using the MAL statement, wherein the assets and liabilities and off-balance sheet positions are pegged on a particular day.*

3.3 **Maintenance of Foreign Exchange Positions**

3.3.1 Licensees are prohibited from carrying out non-trade related forex transactions of a speculative nature. Licensees may help companies in the Sultanate in their genuine hedging requirements to cover open trade positions through Shari’a compliant products as approved by their SSBs.

3.3.2 Licensees are not allowed to take positions in Foreign Exchange except within the limits and conditions prescribed by the Central Bank.

3.3.3 The limit is hereby specified to be not more than 40% of the Licensee’s capital and reserves within the Sultanate. Provisions shall not be included in such calculations.

3.3.4 This limit shall apply to all foreign currencies without exception. The foreign exchange position of a Licensee is defined as the aggregate of all overbought and oversold positions.

3.3.5 Licensees shall submit data showing their foreign exchange positions in accordance with the forms set by the Central Bank for this purpose, and these shall be submitted to the Central Bank together with the monthly returns.
3.4  **Foreign Currency financing**

3.4.1 Licensees are encouraged to mobilize resources with foreign currency financing arrangements from abroad since such resources are supplementary source of funds for the Licensees to help in the development of the economy.

3.4.2 The Licensees shall obtain prior approval of the Central Bank before entering into any agreement for medium term and long term financing from any foreign bank/ institution/ financier. The tenures of the financing are defined in the table below:

<table>
<thead>
<tr>
<th>Financing by Tenure</th>
<th>Definition</th>
<th>Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Short term</td>
<td>Financing with a time to maturity of up to one year from a given date</td>
<td>Up to 100% of net worth.</td>
</tr>
<tr>
<td>2 Medium term</td>
<td>Financing with a time to maturity of one to five years from a given date</td>
<td>Up to 200% of net worth. This limit should include the limit specified for (1) above</td>
</tr>
<tr>
<td>3 Long term</td>
<td>Financing with a time to maturity of over five years from a given date</td>
<td>Up to 300% of net worth. This limit should include the limits specified for (1) and (2) above.</td>
</tr>
</tbody>
</table>
3.4.3 The Licensees shall restrict their foreign currency funding to the limits as discussed in the table above.

3.4.4 *The Central Bank expects that the Licensees would negotiate the settlement of medium and long term financing progressively in instalments during the life span of the financing so that the residue would not cause much strain to the Licensee when the maturity falls into short term.*

3.4.5 The Licensees shall retain medium or long term financing which involves bullet payments within the respective time bands up to the time of the settlement of such financing. It should also be noted that the exact period of liability of such financing should, however, be shown by the Licensees in the statement on maturity profile of assets and liabilities submitted to the Central Bank on a quarterly basis.

3.4.6 When submitting applications to the Central Bank for prior approval of such financing, the Licensees shall furnish all the relevant details including the need and terms.

3.5 **Dealing Room**

3.5.1 Licensees may, if they so wish, operate their Dealing Rooms on a 24 hour basis throughout the working week and also during International Working Days (Thursdays, Fridays and Oman holidays which fall on International Working days).

3.5.2 Licensees shall develop dealing room policies to be followed by dealers while undertaking dealing transactions

3.5.3 *Licensees should ensure that adequate and satisfactory internal control systems and procedures are in place in their Dealing Rooms to cope with the increased activity that may arise from the long dealing hours.*
4. **Equity Investment Risk**

4.1 **Background**

4.1.1 *Equity Investment Risk* is risk to earnings or capital that results from adverse changes in the value of equity related portfolios of a financial institution. This section sets out the principles pertaining to the management of risks inherent in the holding of equity instruments for investment purposes.

4.1.2 *For Licensees, the relevant instruments are typically those based on the Mudaraba and Musharaka contracts. While investments made via Mudaraba and Musharaka instruments may contribute substantially to a Licensee’s earnings, they entail significant market, liquidity, credit and other risks, potentially giving rise to volatility in earnings and capital.*

4.1.3 *The capital invested through Mudaraba and Musharaka may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, a Licensee may invest at different investment stages.*

4.1.4 *One distinct difference between Mudaraba and Musharaka financings is in terms of the Licensees’ involvement in the investments during the contract period. In Mudaraba, the Licensees invest their money as silent partners and the management is the exclusive responsibility of the other party, namely the Mudarib. In contrast, in Musharaka financing the Licensee and its partner or partners invest their funds together, and the Licensee may be a silent partner or may participate in management. Regardless of the authority under which the profit sharing instruments are used, both Musharaka and Mudaraba are profit-sharing financings under which the capital invested by the provider of finance does not entail a fixed return, but is explicitly exposed to impairment in the event of losses (capital impairment risk).*

4.1.5 *Price risk associated with equities could be systemic or otherwise. The former refers to sensitivity of portfolio’s value to changes in overall level of equity prices, while the latter is associated with price volatility that is determined by firm specific characteristics.*

4.2 **Non-Traded Equity Investment Risk**

4.2.1 *The type of equity investment risk dealt with in this section may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.*
4.2.2 The characteristics of such equity investments include considerations as to the quality of the partner, underlying business activities and ongoing operational matters. By nature, this type of equity investment is exposed to a confluence of risks associated with Mudarib or Musharaka partner, business activity and operations.

4.2.3 In evaluating the risk of an investment using the profit sharing instruments of Mudaraba or Musharaka, the risk profiles of potential partners (Mudarib or Musharaka partner) are crucial considerations for the undertaking of due diligence. Such due diligence is essential to the fulfilment of Licensees’ fiduciary responsibilities as an investor of funds on a profit-sharing and loss-bearing basis (Mudaraba) or a profit and loss sharing basis (Musharaka). These risk profiles include the past record of the management team (integrity, qualification, experience, coherence as a team, etc), the nature and size of market opportunity and quality of the business plan of the proposed Mudaraba or Musharaka activity, among other things.

4.2.4 Factors relating to the legal and regulatory environment affect equity investment performance, and need to be considered in the risk evaluation. These factors include policies pertaining to tariffs, quotas, taxation or subsidies and any sudden policy changes affecting the quality and viability of an investment.

4.2.5 Licensees are exposed to the risks attached to a lack of reliable information on which to base their investment appraisals, such as an inadequate financial control system. The mitigation of these risks may require the investor to take an active role in monitoring the investment, or the use of specific risk mitigating structures.

4.2.6 Although timely allocation of profit can be agreed upfront, Licensees should be prepared for delays and variations in cash flow patterns and possible difficulties in executing a successful exit strategy.

4.2.7 The risks arising from the use of profit sharing instruments for financing purposes do not include credit risk in the conventional sense, but share a crucial characteristic of credit risk because of the risk of capital impairment, management of which is discussed in the Credit Risk title.

4.3 Non-Traded Equity - Operational Considerations

4.3.1 Licensees shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudaraba and Musharaka investments.

4.3.2 Licensees shall define and set the objectives of, and criteria for, investments using profit sharing instruments, including the types of investment, tolerance for risk, expected returns and desired holding periods. For example, a Musharaka
structure may contain an option for redemption whereby the Licensees as financiers have a contractual right to require their partner periodically to purchase, under a separate contract, a proportion of the Licensee’s share in the investment at net asset value or, if the contract so specifies, on some agreed basis (Diminishing Musharaka).

4.3.3 Licensees shall have, and keep under review, policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from profit sharing investments. Licensees shall ensure proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which Licensees invest as partners. These should include evaluation of Shari’a compliance, adequate financial reporting by, and periodical meetings with, partners and proper recordkeeping of these meetings.

4.3.4 Licensees shall identify and monitor the transformation of risks at various stages of investment lifecycles, especially where the investee’s business involves innovative products or services in the marketplace. Licensees that employ different financing instruments at different contract stages shall have appropriate procedures and controls in place, as different stages may give rise to different risks.

4.3.5 Licensees shall analyse and determine possible factors affecting the expected volume and timing of cash flows for both dividends and capital gains arising from equity investments.

4.3.6 Licensees shall use Shari’a compliant risk-mitigating techniques which reduce the impact of possible capital impairment of an investment. This may include the use of Shari’a permissible security from the partner.

4.3.7 Licensees shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impact of their methods on profit calculations and allocations. The methods shall be mutually agreed between the Licensees and the Mudarib and/or Musharaka partners.

4.3.8 Licensees shall agree with the Mudarib and/or Musharaka partners, before entering into any agreement, on the appropriate valuation methods and periods for which the profit is to be calculated and allocated taking into account market practices and liquidity features. Valuation and accounting play an important role in measuring the quality of an equity investment, especially in a privately held entity, for which independent price quotations are neither available nor sufficient in volume to provide a basis for meaningful liquidity or market valuation. An
appropriate and agreed method to be applied to determine the profit of the investment can be in the form of a certain percentage of either gross or net profit earned by the Mudaraba or Musharaka business, or any other mutually agreed terms. In the case of a change of the partnership’s shares in a Musharaka (for example in a Diminishing Musharaka), the shares changing hands shall be valued at fair value or on some other mutually agreed basis as approved by the Shari’a Supervisory Board.

4.3.9 Licensees shall assess and take measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings. Reported earnings can be either gross or net. If for some reason the practices of smoothing profits over accounting periods and the establishment of escrow accounts to hold certain profit portions during the life of an equity investment are recognised and agreed by all the investing parties, the Licensees shall incorporate their potential impact in their overall earnings.

4.3.10 Licensees shall agree with the Mudarib and/or Musharaka partners to engage independent parties where necessary to carry out audits and valuations of the investments. Provided these are properly executed and completed, these measures will help to ensure transparency and objectivity in valuation, in the distribution of profits and in the determination of amounts to be redeemed.

4.3.11 Licensees shall define and establish exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudaraba and Musharaka investments, subject to the approval of the institution’s Shari’a Supervisory Board.

4.3.12 Licensees shall establish the criteria for exit strategies, including the redemption of equity investments and the divestiture of under-performing investments. The criteria may include alternative exit routes and the timing of exit. In case of losses where improved business prospects exist, Licensees may indicate an investment extension period. Licensees’ expectations should be based on their assessment that there are plausible grounds for believing that there will be a business turnaround during the period resulting in the view that the investment will, in time, recover and yield profits.

4.3.13 Licensee shall recognise that, as a going concern, an investee may not always have the liquidity necessary to enable making profit distributions. Hence, Licensee shall agree with the investment partner the methods for the treatment of retained profits by the investee.
4.4 Investments in Shares and Securities of Other Corporations / Entities

4.4.1 Licensees are allowed, subject to the conditions listed hereunder, to operate freely within the limits already stipulated in the Banking Law and subject to Shari’a compliance.

4.4.2 Licensees are forbidden from investing in shares of other Licensees. Prior reference shall be made to the Central Bank for investments in related companies. The Central Bank will monitor the Licensees’ performance in this regard and will take steps, whenever deemed appropriate.

4.4.3 Total of investments in shares and securities, at a given date, of a particular corporation / entity, shall not exceed five (5) percent of the issued shares of such corporation / entity and that all such investments together shall also not exceed twenty (20) percent of the net worth of the Licensee. Investments overseas shall not exceed 5% of the networth within the above 20% limit.

4.4.4 Licensees will be guided by Article 65 b (4) of the Banking Law.

4.4.5 Licensees should exercise “due diligence” when pursuing these investments, and put to use the experience gathered over the years in assimilating and analyzing market data, such as stock price movements and the play of market forces.

4.4.6 Licensees shall promptly submit quarterly statements of investments to the Manager, Banking Development Department not later than the 15th of the following month after the end of the quarter. The statements should separately list investments (shares, Sukuk etc.), categorize them (currency-wise, local and overseas, held to maturity, available for sale, trading etc.) and arrive at sub-totals / total with reference to respective regulatory entitlements. The returns should indicate the capital of the investees, wherever applicable, and indicate if the limitations on individual share investments are complied with. The returns should be accompanied by a certificate confirming accuracy and adherence to all applicable instructions and also a brief write-up on significant issues, if any, relating to the performance of the overall portfolio and any related aspect.

4.4.7 The Central Bank expects the Licensees to be reasonably conservative in investment decisions and have appropriate balance between risks and rewards. Further, the classification, valuation etc. will be governed by the Central Bank’s approved accounting standards.

4.4.8 Licensees shall set in place comprehensive investment policy and procedures, duly approved by their Board of Directors. The document will cover all aspects including investment policy, objectives and strategies, guidelines on
public/private subscriptions, quoted/unquoted and listed/unlisted investments, valuations, delegated powers, risk management aspects like diversification of portfolio, defined country, currency, industry and other exposures, suitable stop-loss limits, on-going reporting and review of exercise of powers and judicious segregation of duties, liquidity norms and exit options, creation of investment fluctuation reserves, countering market, operational and other risks, etc. All investment decisions will be backed up by appropriate research/professional advice. The investment policy shall fit into the overall business profile and risk management regime of the Licensee. The Board should review the investment portfolio at least quarterly and take appropriate steps without prejudice to provision for timely action in emergent circumstances.

4.4.9 Licensees shall provide a copy of the investment policy/guidelines, evolved as above, to reach the Vice President, Banking Control Departments & Legal promptly after commencing the investments division within the Licensee.

4.4.9.1 Licensees shall exercise due diligence and ensure adequate provisioning in their year-end financials in marketable equity securities (the lower of cost and market value determined on a portfolio basis at prices prevailing at the end of the year), in full compliance with relevant International Accounting Standards.

4.4.9.2 Licensees shall incorporate adequate disclosures on the overall performance of such stocks in their reports.
5. Rate of Return Risk

5.1 Background

5.1.1 This Article sets out principles in respect of rate of return risks. The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers.

5.1.2 Since Licensees’ responsibility is to manage their Investment Account Holders’ (IAHs) expectations and their liabilities to current account holders, the rate of return risk is a strategic risk issue forming part of Licensees’ balance sheet risk management.

5.2 Definition and Profiles of Rate of Return Risk

5.2.1 Licensees are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs’ having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that the Licensees are concerned with the result of their investment activities at the end of the investment holding period. Such results cannot be pre-determined exactly.

5.2.2 A consequence of rate of return risk may be displaced commercial risk. Licensees may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors’ rates. Licensees may decide to waive their rights to part or their entire Mudarib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on Licensees to attract and retain investors (fund providers). The decision of the Licensees to waive their rights to part or all of their Mudarib share in profits in favour of IAH is a commercial decision, based on clear and well defined policies and procedures approved by the Licensee’s Board of Directors and in line with the guidance of their Shari’a Supervisory Board.

5.2.3 A Profit Equalisation Reserve (PER) is the amount appropriated by the Licensees out of their gross income, before allocating the Mudarib share, in order to maintain a certain level of return on investment for IAH. The basis for computing the amounts to be so appropriated should be pre-defined and applied in accordance with the contractual conditions accepted by the IAH and after formal review and approval by the Licensees’ Board as well as Shari’a Supervisory Board. The Central Bank may lay down requirements relating to the maintenance of the PER.

5.2.4 An Investment Risk Reserve (IRR) is the amount appropriated by the Licensees out of the income of IAH, after allocating the Mudarib share, in order to cushion the effects of
the risk of future investment losses on IAH. The terms and conditions whereby IRR can be set aside and utilised should be determined and approved by the Board as well as Shari’a Supervisory Board.

5.3 Operational Considerations

5.3.1 Licensees shall establish a comprehensive risk management and reporting process to assess the potential impact of market factors affecting the rates of return on assets in comparison with the expected rates of return for investment account holders.

5.3.2 Licensees shall take necessary steps to ensure that the management processes relating to the identification, measurement, monitoring, reporting and control of the rate of return risk (including appropriate structure) are in place. Since the rate of return risks emanate from various balance sheet positions, the Licensees shall have in place competent staff to undertake the analysis of risk exposures arising from their consolidated balance sheet activities.

5.3.3 Licensees shall be aware of the factors that give rise to rate of return risk. The primary form of rate of return risk to which the Licensees are exposed is increasing long-term fixed rates in the market. In general, profit rates earned on assets reflect the benchmark of the previous period and do not correspond immediately to changes in increased benchmark rates.

5.3.4 Licensees shall assess the effect of the level of their dependency on current account holders’ funds. Although no returns are expected by current account holders, the sudden withdrawal of these funds can have an adverse impact on the overall potential rate of return for the Licensees.

5.4 Rate of Return Risk Management

5.4.1 Licensees shall have in place appropriate systems for identifying and measuring the factors which give rise to rate of return risk.

5.4.2 When calculating a rate of return, the Licensees shall employ a Maturity Gap Analysis for allocating positions into time bands with remaining maturities or repricing dates, whichever is earlier. Fixed and floating rate assets of the Licensees will be classified according to their receivable dates because the returns on these receivables represent the fund providers’ direct and beneficial ownership of the assets. Actual cash flows may indicate a gap for a given time band, affecting the rate of return for that period. Depending on the complexity and the nature of their business operations, Licensees may employ techniques ranging from
simple gap to advance simulation or dynamic approaches to assess future cash flow variability and net income. The estimates derived from selected approaches may provide acceptable approximations of periodic future earnings’ variability; hence, the outcomes will yield different levels of expected returns to IAH.

5.4.3 The measurement of rate of return risk highlights the importance of cash flow forecasting for instruments and contracts where Licensees are required to simulate and assess their behavioural maturity, underlying assumptions and parameters, which must be reviewed periodically for reliability. The materiality of potential threats to future earnings and the usefulness of the resulting information shall be considered in determining the type and extent of forecast behaviour for the Licensees.

5.4.4 In assessing whether a potential threat is likely to have a material, likely and imminent impact on a balance sheet position, the Licensees will ensure that they understand the different characteristics of their balance sheet positions in the different currencies and jurisdictions within which they operate.

5.4.5 In assessing exposure to rate of return risks, Licensees shall take into account the non-contractual behavioural maturity of the transactions in the context of the environment in which they operate and changing market conditions. For example, in case of early repayment made by the customer (in Murabaha or Ijarah transactions) in certain countries, the Licensees may accept full settlement but give rebates on subsequent transactions, while in other countries, the Licensees may give rebates immediately at their discretion without any reference to this in the contract.

5.4.6 Licensees are encouraged to employ balance sheet techniques to minimise their exposures using the following strategies, among others:

5.4.6.1 determining and varying future profit ratios according to expectations of market conditions;

5.4.6.2 developing new Shari’a-compliant instruments; and

5.4.6.3 issuing securitisation tranches of Shari’a permissible assets. (Securitization needs to follow applicable rules in force from time to time.)

5.4.7 Licensees are encouraged to exercise simple stress testing by applying certain percentage increase in the rate of return on both assets and liabilities maturing, or by being re-priced at various maturity buckets in order to yield a measure of potential loss (or gain) due to a uniform shift in term structure of the rate of return.
5.5 Displaced Commercial Risk Management

5.5.1 Licensees shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

5.5.2 Licensees shall have in place a policy and a framework for managing the expectations of their shareholders and IAH. Where market rates of returns of competitors’ IAH are higher than those of the Licensees’, the Licensees will evaluate the nature and extent of the expectations of their IAHs and assess the amount of the gap between competitors’ rates and their own IAHs’ expected rates.

5.5.3 Licensees need to develop and maintain an informed judgment about an appropriate level of the balances of PER, bearing in mind that its essential function is to provide mitigation of displaced commercial risk. Licensees shall maintain the proportion relating to IAH in this reserve within the IAH equity, with the purpose of smoothing returns to IAH, and in particular, to enhance their returns if these are below those of the competitors. This implies that there will be years in which the balance of this reserve will be increased, and others in which it will be depleted. With respect to the treatment of PER and IRR, the Licensees should rely on fair, diligent and Shari’ā compliant practices for the benefit of the IAHs.
TITLE 8: OPERATIONAL RISK

Islamic Banking Regulatory Framework
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1. General Rules and Guidance

1.1 Definition and Profile of Operational Risk

1.1.1 This section sets out the principles pertaining to appropriate systems and controls to address Licensees’ operational risks. Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people or systems or external events, which includes but is not limited to, legal risk and Shari’a compliance risk. This definition excludes strategic, reputational and systemic risks.

1.1.2 Managing operational risk is becoming an important feature of sound risk management practices in modern financial markets in the wake of substantial increase in the volume of transactions, growing sophistication of financial technology, growth of e-commerce, emergence of banks as very large volume service providers, greater outsourcing for transaction processing, complex support systems, etc.

1.1.3 The most important type of operational risk involves breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial loss through error, fraud or failure to perform in a timely manner causing the interest of the Licensees to be compromised. An effective Management Information System (“MIS”), a strong internal control culture and contingency planning are all crucial elements of effective operational risk management for Licensees of any size and scope.

1.1.4 Licensees are exposed to risks relating to Shari’a non-compliance and risks associated with the Licensees’ fiduciary responsibilities towards different fund providers. These risks expose the Licensees to fund providers’ withdrawals, loss of income, voiding of contracts leading to a diminished reputation or the limitation of business opportunities.

1.1.5 Shari’a non-compliance risk is the risk that arises from Licensees’ failure to comply with the Shari’a rules and principles determined by the respective Shari’a Supervisory Boards (SSB) of the Licensees and / or any other relevant body in the jurisdiction in which the Licensees operate.

1.1.6 Shari’a compliance is critical to Licensees’ operations and such compliance requirements must permeate throughout the organisation, encompassing their products and activities. As a majority of the fund providers use Shari’a compliant banking services as a matter of principle, their perception regarding Licensees’ compliance with Shari’a rules and principles is of great importance to their sustainability. In this regard, Shari’a compliance is considered as falling within a...
higher priority category in relation to other identified risks. If Licensees do not comply with Shari’a rules and principles, their transactions may be cancelled, income generated from them may be considered as illegitimate and hence donated to charity at the instruction of the SSB. If the Licensees are perceived by the stakeholders as being Shari’a non-compliant, their reputation may be tarnished and their sustainability can be called into question if investment account holders start to withdraw their funds or switch to other financial institutions.

1.1.7 Fiduciary risk is the risk that arises from Licensees’ failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, Licensees may become insolvent and therefore unable to (a) meet the demands of current account holders for repayment of their funds; and (b) safeguard the interests of their Investment Account holders (“IAH”). Licensees may fail to act with due care when managing investments resulting in the risk of possible forgone profits to IAH. In the case of Shari’a compliant banking, fiduciary transactions are substantial and therefore commensurate care needs to be exercised against operational risks relating to them.

1.1.8 While managing their operational risk profile, Licensees have to consider that they may be exposed to higher levels of operational risk compared to their conventional counterparts. This is due to the fact that:

1.1.8.1 They are expected to hold on their balance sheets more physical assets and so they are exposed to operational risk associated with these assets.

1.1.8.2 Through the use of Shari’a compliant financing contracts, the number of operations executed may be higher than in conventional banking.

1.1.8.3 The industry is still young and that there is a lack of consistency on best practices.

1.1.8.4 The maturity level and robustness of the core banking software for the unique needs of the industry are relatively lower than the conventional banking industry.

1.1.8.5 The scarcity of experienced Islamic banking skills and resources.

1.1.9 Licensees should give attention to the following operational risks that may arise from specific financing modes. The list is only illustrative and should not be considered as a comprehensive listing of related risks.

1.1.10 Murabaha:

1.1.10.1 Terms and specifications of the Murabaha contract may not match with the terms and commercial specifications of the transaction (like L/Cs discrepancies in local and foreign trade transactions).
1.1.11 Salam and Parallel Salam:

1.1.11.1 The operational risk related to the early delivery of the contracted goods (if accepted by the Licensee) may result in additional costs incurred by the Licensee such as warehousing, insurance/Takaful or other damages in case of perishable commodities.

1.1.11.2 The Licensee may face legal risk if the commodities cannot be delivered at the agreed upon time (unless the customer under Parallel Salam agrees to modify the delivery date).

1.1.12 Istitna’a and Parallel Istitna’a:

1.1.12.1 The Licensee may be unable to deliver the asset contracted for in a timely manner and face penalties for late completion.

1.1.12.2 Cost overruns under the Parallel Istitna’a contract may be incurred partly or wholly by the Licensee unless mutually agreed otherwise with the customer.

1.1.12.3 The sub-contractor may fail to meet the quality standards or other requirements specified in the contract.

1.1.12.4 The sub-contractor may be unable to complete the work and the Licensee may have to find an alternative with higher cost.

1.1.13 Ijarah and Ijarah Muntahia Bittamleek:

1.1.13.1 If the lessee damaged the assets in its possession and the Licensee faces the lessee’s refusal to rectify the situation.

1.1.14 Musharaka:

1.1.14.1 Failure of the Licensee to perform adequate due diligence in appraising the venture project and the soundness and reliability of its partner which could result in the failure of the business.

1.1.14.2 Lack of adequate monitoring by the Licensee of the joint venture business.

1.1.15 Mudaraba:

1.1.15.1 Operational risk may arise if the Licensee incurs losses due to its failure to perform adequate due diligence before advancing the funds to the Mudarib.

1.2 Operational Considerations

1.2.1 The controls within the Licensees shall provide reasonable assurance of the soundness of operations and reliability of reporting. Licensees shall consider the full range of material operational risks affecting their operations,
including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

1.2.2 Licensees shall also incorporate possible causes of loss resulting from Shari’a non-compliance and the failure in their fiduciary responsibilities.

1.2.3 Licensees shall have in place a comprehensive and sound framework for developing and implementing a prudent control environment for the management of operational risks arising from their activities guided among others by provisions in Article 4.4 on operations and 4.5 on customer due diligence of Title 2 on General Obligations and Governance.

1.2.4 The above framework shall be consistently implemented throughout the organisation and understood by all relevant staff.

1.2.5 Taking into account institution-specific factors, Licensees may consider establishing an independent bank-wide Operational Risk Committee or Unit, which should be placed directly under the Risk Management Committee (“RMC”) or the Chief Risk Officer (if it is a Unit). The Committee or the Unit should be responsible for establishing consistent definition for operational risk across business units, developing policies, procedures and practices, reporting and review of risk exposures, overseeing and ensuring the integrity of risk assessment procedures, allocation and maintenance of economic capital, development of strategies for risk mitigation techniques, etc. The responsibilities of the functionaries shall be defined in a manner that they are mutually exclusive and all conflicts of interest are avoided.

1.3 Shari’a Non-Compliance Risk

1.3.1 Licensees shall have in place adequate systems and controls, including Shari’a Supervisory Board and Internal Shari’a Reviewer, to ensure compliance with Shari’a principles.

1.3.2 Licensees shall ensure that they comply at all times with Shari’a principles as determined by their respective SSB, the Central Bank and/or any other relevant body as determined by law / regulations from time to time with respect to their products / services and business activities. This means that Shari’a compliance considerations are taken into account whenever the Licensees accept deposits and investment funds, provide financing and carry out investment services for their customers.

1.3.3 Licensees shall ensure that their contract documentation complies with Shari’a rules and principles with regard to formation, termination and
elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations.

1.3.4 Licensees shall undertake Shari’a compliance review, performed by the internal Shari’a audit unit having the required knowledge and expertise for the purpose, as stated in Title 2 on General Obligations and Governance, so as to address related operational risks. The objective is to ensure that the Licensees’ funding and financing activities and their operations are executed in adherence to the applicable Shari’a rules and principles as per the Fatawa, policies and procedures approved by the Licensees’ SSB.

1.3.5 Licensees shall put in place an efficient and timely reporting system to the SSB.

1.3.6 Licensees shall keep track of income arising inadvertently out of any Shari’a non-compliant activity or transaction, and assess the probability of similar cases in the future. Based on historical reviews and potential areas of Shari’a non-compliance, the Licensees may assess potential profits that cannot be recognised as eligible Licensees’ profits. Such profits shall be transferred to the Charity Fund account.

1.3.7 The Charity Fund account of the Licensee shall be reviewed for Shari’a compliance and to ascertain if the amount has been given to a recognized charity organization and not to a related party.

1.3.8 Shari’a requirements that are to be complied with by the Licensees in respect of the financing contracts are given below. The list is not exhaustive and may vary according to the views of the various Shari’a Supervisory Boards.

1.3.9 Murabaha and Ijarah contracts:

1.3.9.1 The asset is in existence at the time of sale or lease or, in case of Ijarah, the lease contract should be preceded by acquisition of the usufruct of that asset except if the asset was agreed upon based on a general specification.

1.3.9.2 The asset is legally owned by the Licensee when it is offered for sale.

1.3.9.3 The asset is intended to be used by the buyer / lessee for activities or businesses permissible by Shari’a; if the asset is leased back to its owner in the first lease period, it should not lead to the contract of Inah (buy-back), by varying the rent or the duration.
1.3.9.4 There is no late payment, penalty fee or increase in price in exchange for extending or rescheduling the date of payment of accounts receivable or lease receivable, irrespective of whether the debtor is solvent or insolvent.

1.3.10 Salam and Istisna’a contracts:

1.3.10.1 Sale and purchase contracts cannot be inter-dependent and inter-conditional on each other, such as Salam and Parallel Salam; Istisna’a and Parallel Istisna’a.

1.3.10.2 It is not allowed to stipulate a penalty clause in respect of delay in delivery of a commodity that is purchased under Salam contract; however, it is allowed under Istisna’a or Parallel Istisna’a.

1.3.10.3 The subject-matter of an Istisna’a contract may not physically exist upon entering into the contract.

1.3.11 Musharaka and Mudaraba contracts:

1.3.11.1 The capital of the Licensee is to be invested in Shari’a compliant investments or business activities.

1.3.11.2 A partner in Musharaka cannot guarantee the capital of another partner, neither a Mudarib can guarantee the capital of the investor (Rabb al Mal) in Mudaraba.

1.3.11.3 The purchase price of other partner’s share in a Musharaka with a binding promise to purchase can only be set as per the market value or as per the agreement at the date of purchase. It is not permissible to stipulate that the share be acquired at its face value.

1.4 Legal Risk

1.4.1 Licensees shall exercise utmost care while documenting the contracts and transactions as their documentation may be new and may not have been tested in the courts.

1.4.2 Licensees may be exposed to legal risk in case of litigation. Licensees shall ensure that the provisions of their commercial and financing transactions are structured in accordance with the prevailing commercial law as well as the Shari’a rules and principles.

1.5 Fiduciary Risk
1.5.1 Licensees shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAHs’ funds are commingled with Licensees’ own funds, Licensees shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with Licensees’ fiduciary responsibilities.

1.5.2 Licensees shall establish and implement a clear and formal policy for undertaking their different and potentially conflicting roles in respect of managing different types of investment accounts. The policy relating to safeguarding the interests of their IAHs may include the following:

1.5.2.1 Identification of investing activities that contribute to investment returns and taking reasonable steps to carry on those activities in accordance with the Licensees’ fiduciary and agency duties, to treat all their fund providers appropriately and in accordance with the terms and conditions of their investment agreements;

1.5.2.2 Allocation of assets and profits between the Licensees and their IAHs shall be managed and applied appropriately to IAHs having funds invested over different investment periods;

1.5.2.3 Determination of appropriate reserves at levels that do not discriminate against the right for better returns of existing IAHs; and

1.5.2.4 Limiting the risk transmission between current and investment accounts.

1.5.2.5 Shari’a Supervisory Board of the Licensee shall ensure that the Core Banking System of the Licensee is Shari’a compliant and tracks which IAHs funds are going / channeling to which investment / financing activity so that the income can be assigned to the IAHs.

1.5.3 Licensees shall adequately disclose information on a timely basis to their IAHs and the markets in order to provide a reliable basis for assessing their risk profiles and investment performance.

1.6 **Restricted Investment Accounts**

1.6.1 Licensees shall maintain separate accounts in respect of Licensees’ operations undertaken for restricted IAHs and ensure proper maintenance of records for all transactions in investments.

1.6.2 To help offset future shortfalls in the rate of return for IAHs in the case of recurring losses, Licensees may set up separate reserves according to the accounts classes or risks. The methods for setting up and using reserves
shall be documented to include the basis for determining the transfers in and out of reserves, maximum thresholds for specific reserves and the use of and closure of specific reserves.

1.6.3 In the case of Licensees raising funds for specific investment purposes, Licensees shall ensure that the IAHs meet certain eligibility qualifications that are consistent with the scale, timeframe and risk level of the investment opportunity. The eligibility requirements may include setting a minimum investment level.

1.6.4 Licensees shall have in place appropriate procedures and controls to ensure the adequacy of the quality of information given in respect of the investment and that the relevant rules and requirements are complied with fully, particularly when marketing an investment opportunity to potential investors. In matters of disclosure, utmost diligence shall be observed to ensure accuracy, clarity, completeness and transparency, avoiding the communication of any misleading information.

1.6.5 In any case, where a separate wholly owned subsidiary or special purpose vehicle is set up by the Licensees as a means to undertaking specific investments or financings (in particular Musharaka), Licensees shall ensure that the risks arising in the subsidiary and/or special purpose vehicle are monitored and reported at the group level (risk management on a consolidated basis). An investment loss arising in a subsidiary or special purpose vehicle may give rise to reputational risk for the Licensees.
2. Measurement, Monitoring and Control

2.1 Measurement of Operational Risk

2.1.1 There is no uniformity of approach in measurement of operational risk in the banking system. Besides, the existing methods are relatively simple and experimental, although some of the international banks have made considerable progress in developing more advanced techniques for measurement and thereby allocating capital with regard to operational risk.

2.1.2 Licensees shall identify the operational risk inherent in all types of products, activities, processes and systems. Further, before introducing or undertaking new products, activities, processes or systems, the operational risk inherent in them shall be subjected to adequate assessment procedures.

2.1.3 Licensees may use risk mapping, key risk indicators, self assessments, score cards etc to identify operational risk exposures. An effective risk identification technique considers both internal factors (such as complexity of structure, nature of activities, quality of personnel, organizational changes and employee turnover) and external factors (like fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the Licensees’ stated objectives.

2.1.4 Licensees shall assess their operations and activities against a menu of operational risk events (internal and external frauds, employment practices and work place safety, clients, products and business practices, damage to physical assets, business distribution and system failures, execution, delivery and process management, etc). Licensees shall, in addition to identifying these factors, also make a clear distinction between controllable and uncontrollable operational risk events.

2.1.5 Under the risk mapping process, various business units and organizational functions or process flows are mapped by risk types. Further, key risk indicators like failed trades, staff turnover rates, frequency and / or severity of errors and omissions should be reviewed to track the magnitude of risk concerns. Licensees shall also set thresholds or limits on key risk indicators.

2.1.6 Measuring operational risk requires both estimating the probability of an operational loss event and the potential size of the loss. It relies on risk factor that provides some indication of the likelihood of an operational loss event occurring. The process of operational risk assessment needs to address the likelihood (or frequency) of a particular operational risk occurring, the
magnitude (or severity) of the effect of the operational risk on business objectives and the options available to manage and initiate actions to reduce/mitigate operational risk. The set of risk factors that measure risk in each business unit such as audit ratings, operational data such as volume, turnover and complexity and data on quality of operations such as error rate or measure of business risks such as revenue volatility, could be related to historical loss experience.

2.1.7 Licensees can also use different analytical or judgmental techniques to arrive at an overall operational risk level. Some of the international banks have already developed operational risk rating matrix, similar to bond credit rating. The operational risk assessment should be on a bank-wide basis and it should be reviewed at regular intervals. Licensees, over a period, should develop internal systems to evaluate the risk profile and assign economic capital within the Risk Adjusted Return on Capital (“RAROC”) framework.

2.1.8 Licensees should begin quantifying operational risk, using simple benchmarks based on an aggregate measure of business activity such as gross revenue, fee income, operating costs, total assets adjusted for off-balance sheet exposures or a combination of these variables.

2.2 Risk Monitoring

2.2.1 The operational risk monitoring system shall focus on operational performance measures such as volume, turnover, settlement facts, delays and errors. It could also be incumbent to monitor operational loss directly with an analysis of each occurrence and description of the nature and causes of the loss.

2.2.2 The frequency of monitoring should reflect the risks involved and the frequency and nature of changes in the operating environment.

2.2.3 Licensees shall conduct periodic reviews to detect and address operational deficiencies. The reviews and evaluation of internal controls shall include independent audit coverage and assessment by internal and/or external auditors.

2.2.4 The system of internal control shall be integrated into the Licensees’ operations and produce regular reports. Apart from reporting to the senior management and the Board, internal audit and risk management departments shall also undertake compliance reviews.
2.3 **Control of Operational Risk**

2.3.1 Internal controls and internal audit are used as the primary means to mitigate operational risk. Licensees could explore setting up operational risk limits, based on the measures of operational risk. The contingent processing capabilities could also be used as a means to contain the adverse impact of operational risk. Insurance (Takaful) is an important mitigation for some forms of operational risk. Risk education for familiarising the complex operations at all levels of staff can also reduce operational risk.

2.3.2 For managing operational risk, the Licensees shall have well-established internal control system, which includes segregation of duties, clear management reporting lines and adequate operating procedures. Most of the operational risk events are associated with weak links in internal control systems or laxity in complying with the existing internal control procedures. Accordingly, internal controls shall be an integral part of the regular activities that enable quick response to changing conditions and avoid unnecessary costs. An effective internal control also requires that there is appropriate segregation of duties and those personnel are not assigned responsibilities that may create a conflict of interest. Assigning such conflicting duties may enable the individuals or groups to conceal losses, errors or inappropriate actions.

2.3.3 The ideal method of identifying problem spots is the technique of self-assessment of internal control environment. The self-assessment could be used to evaluate operational risk along with internal / external audit reports / ratings or Central Bank’s examination findings. Licensees should endeavour for detection of operational problem spots rather than their being pointed out by internal or external auditors or the Central Bank.

2.3.4 Along with activating internal audit systems, the Audit Committees should play greater role to ensure independent financial and internal control functions.

2.3.5 Licensees shall proactively adopt risk mitigation techniques for managing significant events of low probability but potentially large financial impacts. Risk mitigation tools or techniques should be used to contain the severity of such events. However, Licensees should view these as complementary, rather than a replacement for and an important mitigation technique in timely resolution of errors.
2.3.6 Licensees may use Shari’a compliant insurance (Takaful) policies, subject to the approval of their SSBs, to externalize the risk of ‘low frequency and high severity losses’ which may occur as a result of events such as errors and omissions, physical loss of securities, frauds and natural disasters.

2.3.7 The salient features of the guidelines on Business Continuity Management (BCM) to be implemented by the Licensees are:

2.3.7.1 Licensees should refer to high-level principles on business continuity given by joint-forum (BIS, BCBS, IOSCO, IAIS, etc.) while finalising their approach to BCM

2.3.7.2 BCM should be made an integral part of overall risk management program.

2.3.7.3 Board shall approve the BCM policy covering identifying, assessing, prioritizing, managing and controlling risk related to BCM.

2.3.7.4 BCM should cover outsourced business also.

2.3.7.5 BCM should be subject to independent review.

2.3.7.6 Establishment of Crisis Management Team (CMT), articulation of roles / responsibilities / authority as well as succession plans, communication strategy to senior management are some features of robust BCM.

2.3.7.7 BCM framework should provide details and establish procedures on various components like a) business impact analysis, b) recovery strategy, c) business continuity plans, d) testing programs, e) training and awareness programs, f) communication and crisis management programs.

2.3.7.8 Licensees should constantly update the BCP and maintain adequate documents. The Chief Executive should prepare and sign-off a formal annual statement to the Board / Head Office / Regional Office on whether the strategies adopted are still valid and whether the documented BCPs are properly tested and maintained. A copy of the same should be submitted to the Central Bank.

2.3.7.9 There shall be half-yearly review by audit on BCM framework.

2.3.7.10 Licensees must notify the Central Bank promptly if BCP is activated and provide regular progress reports till the BCP is de-activated.

2.3.8 Licensees shall adopt appropriate information technology tools and techniques for risk mitigation. Sound application of IT can transform ‘low frequency and high severity losses’ into ‘low frequency low severity losses’.
Licensees shall also establish sound policies for managing risks associated with outsourcing activities. Such activities should be based on rigorous legal agreements, particularly the external parties’ liabilities and financial ability to compensate the Licensee for errors, negligence and other operational failures. Licensees should carry out due diligence tests and monitor the activities of third party service providers. A contingency plan should also be in place to handle failure situations and switching to alternative service providers at short notice. Licensees may consider outsourcing only in non-core areas except in very rare cases where ample justifications exist and prior approval of the Central Bank is obtained.

Licensees should ensure that there is adequate knowledge and skill available within the Shari’a Compliance Unit so as to understand and interpret the SSB’s Fatawa, rulings and guidelines sufficiently to address the banking requirements.

Licensees shall ensure that the IT systems are robust and meet all the requirements of Islamic banking. Licensees shall ensure that there are an adequate change management processes when developing and rolling out new IT systems.

Conventional banks seeking to introduce Islamic banking business through Islamic Windows should adjust their systems and introduce relevant new structures so as to suit the special nature of Islamic operations within the whole banking framework. Failing to do so may result in substantial operational risk issues for them.

Licensees shall ensure that audit trail is maintained at all times in all activities. Licensees shall further ensure that such records of audit trails are properly stored.
3. **Combating Money Laundering and other Financial Crimes**

3.1 **Combating Money Laundering and Terrorist Financing**

3.1.1 In order to combat money laundering and/or terrorist financing, the following measures should be considered by the Licensees:

3.1.1.1 Ensure the identity of customers. It should be directly done (not through third parties) before a relationship is established and supported by reliable official documents.

3.1.1.2 Extend the identity ascertainment exercise to all customers, be they natural or otherwise. Juristic persons shall have their official licensing / registration / recognition completed beforehand and file copies / evidence thereof. When pre-operative / non-face to face electronic transactions are inevitable before physical receipt of documents, there should be adequate follow up system to obtain documents in time and ensure that no material transaction takes place defeating the objective of AML/CFT vision. Knowing the customer shall not end with commencement of business relationship or opening an account. It should be on-going. It is necessary to set up and execute a process of review of due diligence and update identity documents periodically.

3.1.1.3 Licensees should be in a position to know and record ownership and control of beneficial interests. Fiduciary transactions, safe deposit facilities and other miscellaneous relationships also need to attract care. Transactions done for third parties require greater attention. Hesitation in disclosure of true ownership should receive note of caution and needed response.

3.1.1.4 There should be no numbered / anonymous / unidentified account. ¹

3.1.1.5 An essential part of banking is record keeping. There shall be completeness and updating in record keeping; the minimum required period under the Anti-Money Laundering Law is 10 years.

3.1.1.6 There should be full awareness among the staff of the Licensee as regard AML and CFT. While recruitment process itself shall have appropriate screening, training should start immediately on recruitment and be repetitive.

3.1.1.7 Usage of technology is helpful in monitoring relationships / voluminous transactions. Suitable programs should be installed and updated. However, this should not be a mechanical process only. Updating technology is a pre-
requisite for catching up with improved sophistication of fraudsters but a high level of alertness and presence of mind are also necessary to achieve the required objectives.

3.1.1.8 Licensees may delegate responsibilities for smooth functioning of the institution but delegation should be with commensurate responsibility. Types of accounts, complexity of relationships, unusual amounts and categories of transactions, etc. will have to be dealt with appropriately with delegation and also supervision. An intelligent oversight system should be built in.

3.1.1.9 Senior management should take effective control over complicated business relationships, mandating risk management system to identify higher risk relationships. Non-resident customers and high value private banking clients could be some of them.

3.1.1.10 It is the senior management’s responsibility to ensure orderliness / completeness in their procedures under policies / guidelines provided by the Board.

3.1.1.11 Audit and Control requirements shall include review of procedures set up.

3.1.1.12 There shall be appropriate escalation of audit observations and scope for timely and effective remedies. Changes in systems and processes as and when needed should be effected promptly.

3.1.1.13 External auditors’ input should be sought for review and assurances.

3.1.1.14 Compliance set up for AML/CFT should receive as much attention as others. Compliance responsibility should be clearly spelt out. If for any genuine reason like smallness of an entity, independent compliance office is not found affordable, it should be ensured that the person with whom concurrent responsibility is assigned has needed time and capabilities, and conflicts of roles are avoided or kept at unavoidable minimum. There should be needed coordination among audit, risk management and compliance.

3.1.1.15 Licensees need to have commensurate policies and procedures to deal with non-resident/external counter parties. Licensees having overseas branches need to ensure compliance as applicable to host countries as well. They should bring any issues / difficulties in compliance to the attention of the Central Bank.

3.1.1.16 There shall be no dealings with shell companies or entities coming under inadequate jurisdictions. Correspondent relationships should not be
established as a matter of routine. They should receive due diligence scrutiny and approval of senior management.

3.1.1.17 The monitoring system should include prompt review by the Licensee within and prompt report of suspicious transactions to the Central Bank. It should cover cash as well as other transactions and attempts to do dubious transactions. Wire transfers shall comply with applicable requirements.

3.2 Enhancing the Role of the Licensees in Combating Money Laundering

3.2.1 Policy

3.2.1.1 Licensees should observe enhanced due diligence process in respect of instances of occasional / unusual transactions. In the light of visa relaxation procedures, there is the likelihood of fraudsters making visits for genuine grounds ostensibly and engaging in laundering ill-gotten money. Some of the money may have emanated from some frauds, in Oman itself. There is a need to pay closer attention to these high risk customers/transactions in terms of exchange of currencies and remittances which contradicts the purpose or scope of their visits.

3.2.1.2 Licensees are advised to be vigilant all the time, and to maintain appropriate identity and record keeping procedures, alertness of staff and internal controls and systems, besides reporting promptly to the Financial Intelligence Unit of the Sultanate of any suspicious transaction.²

3.2.1.3 Licensees should take additional measures as deemed appropriate. Preventive measures must be taken to review critically the security features of their machines and update them, monitor the ATMs periodically for any external apparatus and suspicious movements, scrutinize unusual transactions, etc. They should communicate with the Royal Oman Police promptly as and when necessary and display a notice in the premises for the attention and guidance of the public. In the instances of new ATM installation or relocation of existing ones the Licensees should take meticulous care as regards appropriateness of the location and security features.³

3.2.2 Procedure

3.2.2.1 Customer identification and record keeping
3.2.2.1 Licensees should not keep anonymous accounts or accounts in obviously fictitious names. They should be able to identify the accounts on the basis of an official or other reliable identifying document and record, the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions in particular opening of accounts or passbooks entering into fiduciary transactions, renting of safe deposit boxes and performing large cash transactions.

3.2.2.1.2 Licensees must take reasonable measures to obtain information about the true identity of the persons on whose behalf an account is opened or a transaction is conducted if there are any doubts as to whether these clients or customers are not acting on their own behalf. In particular, in the case of domiciliary companies i.e. institutions, corporations, foundations, trusts, etc. that do not conduct any commercial or manufacturing business or any other form of commercial operation in the country where their registered office is located.

3.2.2.1.3 Licensees should maintain their records for at least ten years – both domestic and international – to enable them to comply swiftly with information requests from the competent authorities. These records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currencies involved, if any) so as to provide, if necessary, evidence for prosecution of criminal behavior.

3.2.2 Increased diligence on financial transactions

3.2.2.2.1 Licensees should pay special attention to all complex, unusual and large transactions and all unusual patterns of transactions which have no apparent economic or visible lawful purpose. The background and purpose of such transactions must be examined and the findings documented in writing and made available to all auditors and law enforcement agencies (if required).

3.2.2.2.2 If Licensees suspect that funds stem from a criminal activity, they are required to report promptly their suspicions to the competent authorities.

3.2.2.2.3 Licensees and their employees are not permitted by the Central Bank to warn their customers when information relating to them is being reported to the competent authorities.

3.2.2.2.4 If and when a Licensee is concerned with the operations of one its customers and it has no obligation to report, it must then sever relations with its client and close the account.
3.2.2.2.5 Licensees must develop programs against money laundering with the following minimum criteria being put in place:

3.2.2.2.5.1 Development of internal policies, procedures and controls including the designation of compliance officers at the management level;

3.2.2.2.5.2 An ongoing employee training program;

3.2.2.2.5.3 An audit function to test the system.

3.2.2.3 Measures to cope with the problems of other countries

3.2.2.3.1 Licensees should give special attention to business relations and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply these recommendations.

3.2.2.3.2 Licensees must ensure that the principles mentioned in this Framework are applied to branches and majority owned subsidiaries located abroad, especially in countries that don’t apply or insufficiently apply these recommendations to the extent that local applicable laws and regulations permit.

3.2.2.3.3 When local applicable laws and regulations prohibit this implementation, competent authorities in the country of the parent institution should be informed by the Licensee that they cannot apply these recommendations.

3.3 Appointment of MLRO and Other Steps to Fight Money Laundering

3.3.1 Licensees must establish electronic data systems and technological programs for monitoring all banking and financial transactions to enhance combating money laundering operations and to facilitate the reporting procedures. These systems should be adaptable with the rules in this Framework.

3.3.2 Licensees must observe the utmost care while vetting the academic qualifications and experience required in a person who is to be appointed as a compliance officer. The person chosen must be a person of distinguished performance, integrity and honesty and should be conversant with the sensitive nature of the post and the relevant issues involved with the job description.

3.3.3 In addition to the rules mentioned in this Title, Licensees should also refer to the 40 recommendations issued by the Financial Action Task Force on
International Standards on combating money laundering and the financing of terrorism & proliferation.
4. Electronic Banking and Electronic Money Activities

4.1 Definitions of Electronic Banking and Electronic Money

4.1.1 Electronic banking refers to the provision of retail and small value banking products and services through electronic channels. Such products and services can include deposit-taking, financing, account management, the provision of financial advice, electronic bill payment and the provision of other electronic payment products and services such as electronic money (defined separately, below).

4.1.2 Two fundamental aspects of electronic banking are the means for customers to gain access to those channels, and the nature of the delivery channels through which activities are pursued. Currently, widely used access devices through which electronic banking products and services can be provided to customers include point of sale terminals, automated teller machines, telephones, personal computers, smartcards and other devices. Common delivery channels include "closed" and "open" networks. "Closed networks" restrict access to participants (financial institutions, consumers, merchants and third party service providers) bound by agreements on the terms of membership. "Open networks" have no such membership requirements.

4.1.3 Electronic money refers to "stored value" or prepaid payment mechanisms for executing payments via point of sale terminals, direct transfers between two devices or over open computer networks such as the Internet. Stored value products include "hardware" or "card-based" mechanisms (also called "electronic purses"), and "software" or "network-based" mechanisms (also called "digital cash"). Stored value cards can be "single-purpose" or "multi-purpose". Single-purpose cards (e.g. telephone cards) are used to purchase one type of good or service, or products from one vendor; multi-purpose cards can be used for a variety of purchases from several vendors. Licensees generally participate in electronic money schemes as issuers, but they may also perform other functions. Those include distributing electronic money issued by other entities; redeeming the proceeds of electronic money transactions for merchants; handling the processing, clearing, and settlement of electronic money transactions and maintaining records of transactions.

4.2 General Considerations

4.2.1 Electronic payment media are likely to continue to figure importantly in the development of electronic commerce, and retail electronic banking services and
products, including electronic money, could provide significant new opportunities for the Licensees. Electronic banking may allow the Licensees to expand their markets for traditional deposit-taking and financing activities, and to offer new products and services or strengthen their competitive position in offering existing payment services. In addition, electronic banking could reduce operating costs for the Licensees.

4.2.2 More broadly, the continued development of electronic banking and electronic money may contribute to improving the efficiency of the banking and payment system and to reducing the cost of retail transactions nationally and internationally. This could potentially result in gains in productivity and economic welfare. Consumers and merchants may be able to increase the efficiency with which they make and receive payments and enjoy greater convenience. Electronic banking may also increase access to the financial system for consumers who have previously found limited access.

4.2.3 The development and use of electronic money and some forms of electronic banking are still in their early stages. The technology for electronic banking and electronic money is changing rapidly, and products and services in the future may be very different from those available today. At the same time, along with the benefits, electronic banking and electronic money activities carry risks for banking organisations, and these risks must be balanced against the benefits.

4.2.4 At this relatively early stage in the development of some electronic banking and electronic money activities, many aspects of risks are neither fully discernible nor readily measurable.

4.2.5 Given the degree of uncertainty about future technological and market developments in electronic banking and electronic money, the Central Bank encourages Licensees to develop a risk management process rigorous and comprehensive enough to deal with known material risks, and flexible enough to accommodate changes in the type and intensity of material risks associated with their electronic banking and electronic money activities.

4.2.6 The risk management process can be effective only if it is constantly evolving. The Licensees shall avoid policies that hamper useful innovation and experimentation.

4.2.7 This section provides considerations for the Licensees as they develop methods for identifying, assessing, managing and controlling the risks associated with electronic banking and electronic money.
4.3 Identification and Analysis of Risks

4.3.1 Because of rapid changes in information technology, no list of risks can be exhaustive. The intention here is to describe a broad, representative set of risks as a basis for designing general guidance for risk management. Categorising risks in this manner can be helpful in systematically identifying risks in a bank.

4.3.2 While the basic types of risks generated by electronic banking and electronic money are not new, the specific ways in which some of the risks arise, as well as the magnitude of their impact on banks, may be new for the Licensees. Some of the risks and problems Licensees may face apply both to electronic money and electronic banking activities. However, there are likely to be differences in the degree to which a particular risk is applicable across different electronic money and electronic banking activities.

4.3.3 Operational risk, reputational risk and legal risk are the most important risk categories for most electronic banking and electronic money activities. Some of the specific problems cut across risk categories. For example, a breach of security allowing unauthorised access to customer information can be classified as an operational risk, but such an event also exposes the Licensees to legal risk and reputational risk. Even though these different types of risks may result from a single problem, appropriate risk management may require several remedies to address each of these different risks.

4.3.4 Other risks may also be important for some forms of electronic banking and electronic money activities and are discussed later in the document.

4.4 Operational Risk

4.4.1 Operational risk arises from the potential for loss due to significant deficiencies in system reliability or integrity. Security considerations are paramount, as Licensees may be subject to external or internal attacks on their systems or products. Operational risk can also arise from customer misuse, and from inadequately designed or implemented electronic banking and electronic money systems. Many of the specific possible manifestations of these risks apply to both electronic banking and electronic money.

4.4.2 Security risks

4.4.2.1 Operational risk arises with respect to the controls over access to a Licensee’s accounting systems, risk management systems, client communication medium and systems used by the Licensee to deter and detect counterfeiting. Controlling access
to bank systems has become increasingly complex due to expanded computer capabilities, geographical dispersal of access points, and the use of various communications paths, including public networks such as the Internet.

4.4.2.2 It is important to note that with electronic money, a breach of security could result in fraudulently created liabilities for the Licensee. Unauthorised access could lead to direct losses, added liabilities to customers or other problems.

4.4.2.3 A variety of specific access and authentication problems could occur. For example, inadequate controls could result in a successful attack by hackers operating via the Internet who could access, retrieve, and use confidential customer information. In the absence of adequate controls, an outside third party could access a Licensee’s computer system and inject a virus into it.

4.4.2.4 In addition to external attacks on electronic money and electronic banking systems, Licensees are exposed to operational risk with respect to employee fraud. Employees could surreptitiously acquire authentication data in order to access customer accounts, or steal stored value cards. Inadvertent errors by employees may also compromise a Licensee’s systems.

4.4.2.5 Risk of criminals counterfeiting electronic money is heightened if Licensees fail to incorporate adequate measures to detect and deter counterfeiting. A Licensee faces operational risk from counterfeiting as it may be liable for the amount of the falsified electronic money balance.

4.4.3 Systems design, implementation and maintenance

4.4.3.1 A Licensee faces the risk that the systems it chooses are not well designed or implemented. For example, a Licensee is exposed to the risk of an interruption or slow down of its existing systems if the electronic banking or electronic money system it chooses is not compatible with user requirements.

4.4.3.2 Many Licensees are likely to rely on outside service providers and external experts to implement, operate and support portions of their electronic money and electronic banking activities. Such reliance may be desirable because it allows a Licensee to outsource aspects of the provision of electronic banking and electronic money activities that it cannot provide economically itself. However, reliance on outsourcing exposes a Licensee to operational risks. Service providers may not have the requisite expertise to deliver services expected by the Licensee, or may fail to update their technology in a timely manner. A service provider’s operations could be interrupted due to system breakdowns or financial difficulties, jeopardising a Licensee’s ability to deliver products or services.
4.4.3.3 The rapid pace of change that characterises information technology presents Licensees with the risk of systems obsolescence. For example, computer software that facilitates the use of electronic banking and electronic money products by customers will require updating, but channels for distributing software updates pose risks for Licensees in that criminal or malicious individuals could intercept and modify the software. In addition, rapid technological change can mean that staff may fail to understand fully the nature of new technology employed by the Licensee. This could result in operational problems with new or updated systems.

4.4.4 Customer misuse of products and services

4.4.4.1 As with traditional banking services, customer misuse, both intentional and inadvertent, is another source of operational risk. Risk may be heightened where a Licensee does not adequately educate its customers about security precautions. In addition, in the absence of adequate measures to verify transactions, customers may be able to repudiate transactions they previously authorised, inflicting financial losses on the Licensee. Customers using personal information (e.g. authentication information, credit card numbers or bank account numbers) in a non-secure electronic transmission could allow criminals to gain access to customer accounts. Subsequently, the Licensee may incur financial losses because of transactions customers did not authorise.

4.5 Reputational Risk

4.5.1 Reputational risk is the risk of significant negative public opinion that results in a critical loss of funding or customers. Reputational risk may involve actions that create a lasting negative public image of overall bank operations, such that the Licensee’s ability to establish and maintain customer relationships is significantly impaired. Reputational risk may also arise if actions by the Licensee cause a major loss of public confidence in the Licensee’s ability to perform functions critical to its continued operation. Reputational risk can arise in response to actions a Licensee itself takes, or in response to actions of third parties. Increased reputational risk can be a direct corollary of heightened risk exposure, or problems in other risk categories, particularly operational risk.

4.5.2 Reputational risk may arise when systems or products do not work as expected and cause widespread negative public reaction. A significant breach of security, whether as a result of external or internal attacks on a bank’s system, can undermine public confidence in a Licensee. Reputational risk may also arise in cases where customers experience problems with a product/service but have not been given adequate information about its use and problem resolution procedures.
4.5.3 Mistakes, malfeasance and fraud by third parties may also expose a Licensee to reputational risk. Reputational risk can arise from significant problems with communication networks that impair customers’ access to their funds or account information, particularly if there are no alternative means of account access. Substantial losses caused by mistakes of another institution offering the same, or similar, electronic banking or electronic money products or services may cause a Licensee’s customers to view its products or services with suspicion, even if the Licensee itself did not face the same problems. Reputational risk may also arise from targeted attacks on a Licensee. For example, a hacker penetrating a Licensee’s website may alter it to intentionally spread inaccurate information about the Licensee or its products.

4.5.4 Reputational risk may not only be significant for a single bank but also for the banking system as a whole. If, for instance, a globally active bank experienced important reputational damage concerning its electronic banking or electronic money business, the security of other banks' systems may also be called into question. Under extreme circumstances, such a situation might lead to systemic disruptions in the banking system as a whole.

4.6 Legal Risk

4.6.1 Legal risk arises from violations of, or non-compliance with, laws, rules, regulations, prescribed practices or when the legal rights and obligations of parties to a transaction are not well established. Given the relatively new nature of retail electronic banking and electronic money activities, rights and obligations of parties to such transactions are, in some cases, uncertain. For example, application of some consumer protection rules to electronic banking and electronic money activities in some countries may not be clear. In addition, legal risk may arise from uncertainty about the validity of some agreements formed via electronic media.

4.6.2 Electronic money schemes may be attractive to money launderers if the systems offer liberal balance and transaction limits, and provide for limited auditability of transactions. Application of money laundering rules may be inappropriate for some forms of electronic payments. Because electronic banking can be conducted remotely, Licensees may face increased difficulties in applying traditional methods to prevent and detect criminal activity.

4.6.3 Licensees engaging in electronic banking and electronic money activities can face legal risks with respect to customer disclosures and privacy protection. Customers who have not been adequately informed about their rights and obligations may
bring lawsuits against a Licensee. Failure to provide adequate privacy protection may also subject a Licensee to regulatory sanctions in some countries.

4.6.4 Licensees choosing to enhance customer service by linking their Internet sites to other sites can also face legal risks. A hacker may use the linked site to defraud a Licensee’s customer, and the Licensee could face litigation from the customer.

4.6.5 As electronic commerce expands, Licensees may seek to play a role in electronic authentication systems, such as those using digital certificates. The role of a certification authority may expose a Licensee to legal risk. For example, a Licensee acting as a certification authority may be liable for financial losses incurred by parties relying on the certificate. In addition, legal risk could arise if Licensees participate in new authentication systems where rights and obligations are not clearly specified in contractual agreements.

4.7 Other Risks

4.7.1 Traditional banking risks such as credit risk, liquidity risk, profit rate risk and market risk may also arise from electronic banking and electronic money activities, though their practical consequences may be of a different magnitude for Licensees than operational, reputational and legal risks.

4.7.2 Credit risk is the risk that a counterparty will not settle an obligation for full value, either when due or at any time thereafter. Licensees engaging in electronic banking activities may extend credit via non-traditional channels and expand their market beyond traditional geographic boundaries. Inadequate procedures to determine the creditworthiness of customers applying for financing via remote banking procedures could heighten credit risk for Licensees. Licensees engaged in electronic bill payment programs may face credit risk if a third party intermediary fails to carry out its obligations with respect to payment. Licensees that purchase electronic money from an issuer in order to resell it to customers are also exposed to credit risk in the event the issuer defaults on its obligations to redeem the electronic money.

4.7.3 Liquidity risk is the risk arising from a Licensee’s inability to meet its obligations when they come due, without incurring unacceptable losses, although the Licensee may ultimately be able to meet its obligations. Liquidity risk may be significant for Licensees that specialise in electronic money activities if they are unable to ensure that funds are adequate to cover redemption and settlement demands at any particular time. In addition, failure to meet redemption demands in a timely
manner could result in legal action against the institution, and lead to reputational damage.

4.7.4 Market risk is the risk of losses in on- and off-balance sheet positions arising from movements in market prices, including foreign exchange rates. Licensees accepting foreign currencies in payment for electronic money are subject to this type of risk.

4.8 Cross Border Issues

4.8.1 Electronic banking and electronic money activities are based on technology that by its very nature is designed to extend the geographic reach of the Licensees and their customers. Such market expansion can extend beyond national borders, highlighting certain risks. Although the Licensees currently face similar types of risks in international banking, it is important to note that these risks are also relevant to the cross-border conduct of electronic banking and electronic money.

4.8.2 Licensees may face different legal and regulatory requirements when they deal with customers across national borders. For new forms of retail electronic banking, such as Internet banking, and for electronic money, there may be uncertainties about legal requirements in some countries. In addition, there may be jurisdictional ambiguities with respect to the responsibilities of different national authorities. Such considerations may expose the Licensees to legal risk associated with non-compliance of different national laws and regulations, including consumer protection laws, record-keeping and reporting requirements, privacy rules and money laundering laws.

4.8.3 Operational risk could arise for a Licensee dealing with a service provider located in another country, which for that reason may be more difficult to monitor. Licensees may also face other risks as they engage in the provision of electronic banking and electronic money activities across borders. Licensees dealing with foreign-based service providers, or with foreign participants in electronic banking or electronic money activities, are subject to country risk to the extent that foreign parties become unable to fulfil their obligations due to economic, social or political factors.

4.8.4 A Licensee offering services via open networks like the Internet may be exposed to credit risk, in that applications for financing from customers in other countries may be more difficult to evaluate with procedures based upon a more familiar customer base. Licensees accepting foreign currencies in payment for electronic money may be subject to market risk because of movements in foreign exchange rates.
4.9 Risk Assessment

4.9.1 Use of electronic banking and electronic money may increase the efficiency of the banking and payment system, benefiting consumers and merchants. At the same time, as the preceding Article indicates, there are risks for Licensees engaging in electronic banking and electronic money activities.

4.9.2 Risks must be balanced against benefits; Licensees shall manage and control risks and absorb any related losses if necessary.

4.9.3 Risks from electronic banking and electronic money activities shall be evaluated in the context of other risks the Licensee faces. Even though electronic banking and electronic money activities may represent a relatively small portion of the overall activities of the Licensees currently, their senior management should assure the Central Bank that their critical systems are not threatened by the risk exposures the Licensees take.

4.9.4 The rapid pace of technological innovation is likely to change the nature and scope of risks the Licensees face in electronic money and electronic banking. Licensees shall have processes that enable management to respond to current risks, and to adjust to new risks. A risk management process that includes the three basic elements of assessing risks, controlling risk exposure and monitoring risks will help the Licensees attain these goals. Licensees shall employ such a process when committing to new electronic banking and electronic money activities.

4.9.5 It is essential that Licensees have a comprehensive risk management process in place that is subject to appropriate oversight by the board of directors and senior management. As new risks in electronic banking and electronic money activities are identified and assessed, the board and senior management must be kept informed of these changes. Prior to any new activity being commenced, a comprehensive review should be conducted so that senior management can ensure that the risk management process is adequate to assess, control and monitor any risks arising from the proposed new activity.

4.9.6 Assessing risks is an ongoing process. It typically involves three steps. First, a Licensee shall engage in a rigorous analytic process to identify risks and, where possible, to quantify them. In the event risks cannot be quantified, management may still identify how potential risks can arise and the steps it has taken to deal with and limit those risks. The management should form a reasonable and defensible judgement of the magnitude of any risk with
respect to both the impact it could have on the Licensee (including the maximum potential impact) and the probability that such an event will occur. A second step in assessing risk is for the board of directors or senior management to determine the Licensee’s risk tolerance, based on an assessment of the losses the Licensee can afford to sustain in the event a given problem materialises. Finally, management can compare its risk tolerance with its assessment of the magnitude of a risk to ascertain if the risk exposure fits within the tolerance limits.

4.10 Managing and Controlling Risks

4.10.1 Having made an assessment of risks and its risk tolerance, the Licensee’s management shall take steps to manage and control risks. This phase of a risk management process includes activities such as implementing security policies and measures, co-ordinating internal communication, evaluating and upgrading products and services, implementing measures to ensure that outsourcing risks are controlled and managed, providing disclosures and customer education, and developing contingency plans.

4.10.2 Senior management should ensure that staff responsible for enforcing risk limits has authority independent from the business unit undertaking the electronic banking or electronic money activity. Licensees shall ensure that the policies and procedures are set out in written documentation and made available to all relevant staff.

4.10.3 Security policies and measures

4.10.3.1 Security is the combination of systems, applications and internal controls used to safeguard the integrity, authenticity and confidentiality of data and operating processes. Licensee shall ensure proper security with development and implementation of adequate security policies and security measures for processes within the Licensee, and for communication between the Licensee and external parties. Security policies and measures can limit the risk of external and internal attacks on electronic banking and electronic money systems, as well as the reputational risk arising from security breaches.

4.10.3.2 The security policy shall state the management’s intentions to support information security and to provide an explanation of the Licensee’s security organization. It shall also establish guidelines that define the Licensee’s security risk tolerance. The policy shall define responsibilities for designing, implementing and enforcing information security measures,
and it may establish procedures to evaluate policy compliance, enforce disciplinary measures and report security violations.

4.10.3.3 Security measures are combinations of hardware and software tools, and personnel management that contribute to building secure systems and operations. Senior management should regard security as a comprehensive process, strong enough to meet any weak link in the process. Licensees can choose from a variety of security measures to prevent or mitigate external and internal attacks and misuse of electronic banking and electronic money. Such measures include, for example, encryption, passwords, firewalls, virus controls and employee screening. Encryption is the use of cryptographic algorithms to encode clear text data into cipher text to prevent unauthorised observation. Passwords, pass phrases, personal identification numbers, hardware-based tokens and biometrics are techniques for controlling access and identifying users.

4.10.3.4 Firewalls are combinations of hardware and software that screen and limit external access to internal systems connected to open networks such as the Internet. Firewalls may also separate segments of internal networks using Internet technology (Intranets). Firewall technology, if properly designed and implemented, can be an effective means of controlling access and safeguarding data confidentiality and integrity. Because this technology is complex to design and can be costly, its strength and capabilities should be proportionate with the sensitivity of the information being protected. A well-planned design should include enterprise-wide security requirements, clear procedures for operation, separation of duties and selection of trusted personnel who are responsible for the configuration and operation of the firewall.

4.10.3.5 Although firewalls screen incoming messages, they do not necessarily protect against virus-infected programs downloaded from the Internet. As a consequence, management should develop prevention and detection controls to reduce the chance of virus attack and data destruction, particularly for remote banking. Programs to mitigate the risk of a virus infection may include network controls, end-user policies, user training and virus detection software.

4.10.3.6 Not all security threats are external. Electronic banking and electronic money systems should also be safeguarded, to the extent possible, against unauthorised activities by current and former employees. As with existing banking activities, background checks for new employees, temporary employees and consultants, as well as internal controls and separation of duties are important precautions to protect system security. For electronic money, additional security measures may help deter attacks and misuse, including counterfeiting and money laundering.
Such measures could include on-line interaction with the issuer or a central operator; monitoring and tracing individual transactions; maintenance of cumulative records in a central database; the use of tamper-resistant devices incorporated into stored-value cards and merchant hardware; and the use of value limits and expiration dates on stored-value cards.

4.10.4 Internal communication

4.10.4.1 Senior management shall communicate to key staff how the provision of electronic banking and electronic money is intended to support the overall goals of the Licensee.

4.10.4.2 Technical staff should clearly communicate to senior management how systems are designed to work, as well as the strengths and weaknesses of these systems. Such procedures can reduce operational risks of poor systems design, including incompatibility of different systems within a banking organisation; data integrity problems; reputational risk associated with customer dissatisfaction that systems did not work as expected; and credit and liquidity risk.

4.10.4.3 To ensure adequate internal communication, all policies and procedures shall be provided in writing. In addition, senior management should adopt a corporate policy of ongoing education and upgrading of skills and knowledge, consistent with the pace of technological innovation, in order to limit operational risks arising from lack of staff and management expertise. Training may include technical course work, as well as time for staff to keep abreast of important market developments.

4.10.5 Evaluating and upgrading

4.10.5.1 Products and services shall be evaluated before they are introduced on a widespread basis. This can also help limit operational and reputational risks. Testing validates that equipment and systems function properly and produce the desired results. Pilot programs or prototypes can be helpful in developing new applications. The risk of system slowdowns or disruptions can also be reduced by policies to review the capabilities of existing hardware and software regularly.

4.10.6 Outsourcing

4.10.6.1 A growing trend in the banking industry is for institutions to focus strategically on core competencies and rely on external parties specialising in activities outside the Licensees’ expertise. While these arrangements may offer benefits such as cost-
reduction and economies of scale, outsourcing does not relieve the Licensee of the ultimate responsibility for controlling risks that affect its operations.

4.10.2 Licensees shall bear the ultimate responsibility for controlling risks that emanate from their outsourced operations.

4.10.3 Outsourcing of activities shall be in compliance with the directives set by the Central Bank.

4.10.4 Licensees shall adopt policies to limit risks arising from reliance on outside service providers. For example, the management should monitor the operational and financial performance of their service providers; ensure that contractual relations between parties, as well as the expectations and obligations of each party, are clearly understood and are defined in written, enforceable contracts; and maintain a contingency arrangement to change service providers in a prompt manner, if necessary.

4.10.5 Security of the Licensees’ sensitive information is of critical importance. The outsourcing arrangement may require the Licensees to share sensitive data with service providers. The management shall evaluate the ability of the service provider to maintain the same level of security as though the activities were conducted in-house, through the review of service providers’ policies and procedures aimed at protecting sensitive data.

4.10.7 Disclosures and customer education

4.10.7.1 Licensees shall make adequate disclosures to their customers about new products and services introduced. They shall undertake efforts to educate customers how to use new products and services.

4.10.7.2 Disclosures and customer education may help a Licensee limit legal and reputational risk. Disclosures and programs to educate customers that address how to use new products and services, fees charged for services and products and problem and error resolution procedures can help Licensees comply with customer protection and privacy laws and regulations. Disclosures and explanations about the nature of a Licensee’s relationship to a linked website may help reduce legal risk to a Licensee arising from problems with services or products on the linked sites.

4.10.8 Contingency planning

4.10.8.1 A Licensee can limit the risk of disruptions in internal processes or in service or product delivery by developing contingency plans that establish its course of action.
in the event of a disruption in its provision of electronic banking and electronic money services.

4.10.8.2 Licensees shall develop plans that address data recovery, alternative data-processing capabilities, emergency staffing and customer service support. Back-up systems shall be tested periodically to ensure their continuing effectiveness. Licensees shall also ensure that their contingency operations are as secure as their normal production operations.

4.10.8.3 Licensees shall document contingency actions they can take in the event service providers become impaired. Such actions could include short-term contracting with other providers and a policy describing how the Licensees will address customer losses associated with the service disruption. Licensees shall reserve the right to change service providers in a prompt manner if necessary.

4.10.8.4 Contingency planning shall contribute to limit reputational risk arising from the Licensees’ own actions, or from problems experienced by another institution offering the same or similar electronic banking or electronic money products or services. For example, Licensees may wish to establish procedures to address customer problems during system disruptions.

4.11 Monitoring Risks

4.11.1 The Licensees shall conduct regular monitoring of risks arising from their electronic banking activities.

4.11.2 Ongoing monitoring is an important aspect of any risk management process. For electronic banking and electronic money activities, monitoring is particularly important both because the nature of the activities is likely to change rapidly as innovations occur, and because of the reliance of some products on the use of open networks such as the Internet. Two important elements of monitoring are system testing and auditing.

4.11.3 System testing and surveillance

4.11.3.1 Testing of systems operations can help detect unusual activity patterns and avert major system problems, disruptions and attacks. Penetration testing focuses upon the identification, isolation and confirmation of flaws in the design and implementation of security mechanisms through controlled attempts to penetrate a system outside normal procedures. Surveillance is a form of monitoring in which softwares and audit applications are used to track activity. In contrast to penetration testing, surveillance focuses on monitoring routine operations,
investigating anomalies and making ongoing judgments regarding the effectiveness of security by testing adherence to security policies.

4.11.4 Auditing

4.11.4.1 Auditing (internal and external) provides an important independent control mechanism for detecting deficiencies and minimizing risks in the provision of electronic banking and electronic money services. The role of an auditor is to ensure that appropriate standards, policies and procedures are developed, and that the Licensee consistently adheres to them. Audit personnel must have sufficient specialised expertise to perform an accurate review. An internal auditor should be separate and independent from employees making risk management decisions. To augment internal audit, management may seek qualified external auditors, such as computer security consultants or other professionals with relevant expertise, to provide an independent assessment of the electronic banking or electronic money activity.

4.12 Management of Cross Border Risks

4.12.1 Cross border risks may be more complex than risks the Licensees face within their home country. Hence, Licensees shall devote added attention to assessing, controlling and monitoring operational, reputational, legal and other risks arising from cross border electronic banking and electronic money activities.

4.12.2 Licensees that choose to provide services to customers in different national markets will need to understand different national legal requirements and develop an appreciation for national differences in customer expectations and knowledge of products and services. In addition, senior management should ensure that existing systems for credit extension and liquidity management take into account potential difficulties arising from cross border activities.

4.12.3 A Licensee shall assess country risk and develop a contingency plan that takes into account service disruptions due to problems in the economic or political climate in that jurisdiction. A Licensee may also face difficulties in enforcing the fulfilment of a foreign service-provider’s obligations. In the case of Licensees relying on service providers located abroad, the Central Bank shall assess the accessibility of information from, and consider the activities of, cross-border service providers on a case-by-case basis.
4.13 **Security Measures to Guard Phishing Attacks on Licensees’ Websites**

4.13.1 Licensees shall, in addition to the overall approach and preventive measures outlined in this Title earlier, take the following specific measures to guard against Phishing attacks on their websites:

4.13.1.1 Enhanced customer awareness through periodical warning messages, Do’s and Dont’s on the Licensees’ websites, cautionary inserts in account statements, SMS alerts, mandating / prompting customers to change their online banking passwords frequently and not to share confidential and sensitive data / information with others;

4.13.1.2 Providing a central point of contact for reporting phishing attacks;

4.13.1.3 Licensees’ swift response to phishing attacks such as blocking of the fake look-alike website, blocking further fraudulent transactions in the affected accounts, seeking customer verification of affected transactions, efforts to track down the beneficiary and freezing his/her account, reporting the financial crime to appropriate authority, etc.

4.14 **Skimming of Cards**

4.14.1 Licensees should continue to invest in more effective systems and controls regarding debit / credit cards and ATMs, including the following:

4.14.1.1 Enhanced safety features on cards by adopting latest technology;

4.14.1.2 Installation of CCTV cameras in ATMs;

4.14.1.3 Increased frequency of monitoring of their own ATMs (to detect insertion of skimming devices);

4.14.1.4 Coordinating with merchants and creating awareness about maintaining confidentiality of information in cards;

4.14.1.5 Blacklisting of fraudulent merchant outlets;

4.14.1.6 Continuous customer education on preventive measures;

4.14.1.7 Greater attention paid to customers travelling abroad, etc.
5. Combating Frauds

5.1 Background

5.1.1 Financial institutions’ primary strength is the trust the public have in them. The trust emanates from the manner in which banks conduct themselves. The conduct is related not only to the business size, efficiency and results but also the management of various risks they are subjected to.

5.1.2 Financial institutions, all over the world, are easy targets for frauds from within and outside since banks deal primarily with large volume of monetary transactions.

5.1.3 The above underpins the need for banks to prepare themselves in dealing with frauds and attempts of frauds as an important risk management requirement. There are financial and reputation risks as well as possibly legal and other risks.

5.1.4 Due diligence requirements in combating frauds have dimensions / implications far beyond Anti-Money Laundering (“AML”) and Combating Financing of Terrorism (“CFT”) vision.

5.1.5 This Article illustrates the broad guidelines to enable the Licensees to combat Fraud related risks.

5.2 Requirements

5.2.1 Licensees shall promptly report frauds and attempts thereof to Royal Oman Police and the Central Bank.

5.2.2 The Board of Directors and the management of the Licensee should take responsibility for ownership, roll out and management of policies, strategies and operational control and other requirements to deal with fraud.

5.2.3 Law of Combating Money Laundering and Terrorism Financing (RD 79/2010) requires the Licensees to report any suspicious transactions to Financial Intelligence Unit of the Sultanate.

5.2.4 Licensees shall distinguish between incidents of fraud and attempts of fraud from the suspicious transaction reporting under the above Law. To a great extent, frauds are incidents of making money cheating others, while money laundering is about transactions relating to ill gotten money and terrorism financing to terrorism related activities / persons.
5.2.4.1 The Boards of Directors of the Licensees shall diligently set appropriate policy for combating frauds. These policies should reflect proactive and preventive vision, besides follow-up vigour in case of occurrence.

5.2.4.2 Senior management of the Licensees shall be required especially to assume responsibility and accountability to implement the policies through commensurate strategies and oversight by the Board.

5.2.4.3 Licensees shall give detailed coverage to the operational requirements, noting that frauds may be aimed at the Licensee, with or without the connivance of insiders. There should be rigorous investigation and deterrent follow-up actions in case of any occurrence.

5.2.4.4 Systems and procedures shall be drawn up diligently and critically reviewed from time to time for improvements. Licensees should be pro-active for critical self-assessment and be better prepared for fraudsters, who keep becoming more and more sophisticated.

5.2.4.5 Licensees shall ensure that same kinds of frauds are not repeated. Repeated fraud reflects poorly on the response of the Licensees on earlier occurrence.

5.2.4.6 Approach and focus vary depending upon the nature of banking activity. For instance, customer interface will receive different attention, as distinct from back office, and so will various facets of Internet banking, investment banking, etc.

5.2.4.7 Necessary ingredients embedded in systems and procedures shall include internal control aspects. The development of a controlled environment encompasses checks and balances through appropriate systems, processes, procedures, oversight, compliance, risk management and audit.

5.2.4.8 Segregation of duties, dual control, reporting to and oversight by the superiors, escalated decision-making and authorizations in high value / high risk / high frequency transactions shall be reflected in the systems and processes. The systems and processes shall in turn be guided by best practices and norms on due diligence, operational controls, risk management, internal audit, external audit, compliance, corporate governance, information security and other security coverage.

5.2.4.9 Electronic banking, non face-to-face transactions and dealings with non-residents including correspondents shall be met with greater care. In the name of risk based approach, attention should not be diluted on areas susceptible to obvious and significant frauds.
5.2.4.10 The culture of awareness and compliance should permeate throughout the organization with encouragement for whistle-blowing with responsibility, protection and reward. No hierarchy should be exempted from this purview and it should be seen as part of corporate / professional responsibility and image building by all concerned.

5.2.4.11 Licensees shall ensure staff and customer awareness and education on various do’s and don’ts on not only new products but various delivery channels like phone banking, Internet banking, etc.

5.3 **Review and Reporting**

5.3.1 Licensees shall have meaningful review mechanisms at the higher levels of management and the Board. While there shall be at least a quarterly review at the management level (risk management committee and the like should assume primary responsibility for review and enforcement of follow-up actions) the Board shall review management reports at least half-yearly to ensure implementation of its vision and directives. These should not be of routine nature and there should be intelligent questioning, follow-up actions and improvements to reduce the chances of future recurrence.

5.3.2 *It will be useful to structure reporting system to categorize frauds and analyze according to activities, market segments, delivery channels, staff and outsider involvement etc., noting that more significant occurrences should receive more immediate attention by the top management and the Board. Any staff involvement should lead to critical review of staff policies (screening and enquiring with Royal Oman Police and others before recruitment, enquiries with previous employers, particularly if they had been in the financial sector, on-going review of staff conduct and their financial and banking relationships and transactions, linkages with related parties, service contracts and agreed terms, conditions and obligations, etc).*

5.3.3 *Training and other means at the Licensee should constantly enhance professional awareness, ethical behaviour and practice of adherence to laid down operational checks and balances.*

5.3.4 Licensees shall set policies to take deterrent actions commensurate with the seriousness of the incidents. Reports to Royal Oman Police should be followed up for outcome, besides initiating suitable immediate actions against staff involvement, if any (e.g. suspension / dismissal on prima facie evidence, as may be warranted, based on service regulations).
5.3.5 Licensees shall inform the Central Bank and Royal Oman Police of all frauds immediately (within three days of occurrence/knowledge) including serious frauds of larger concern requiring more expeditious report in the interests of concerned institutions and others. The reporting to the Central Bank in case of frauds shall include the following:

5.3.5.1 The reports to the Central Bank shall be self-explanatory to contain, among others, date of occurrence / knowledge, the name and available details of the fraudster, amount involved, place of occurrence, modus operandi, confirmation that the Royal Oman Police has been informed, further direct course of action being planned (including internal investigation, its likely date of completion and sharing of response), staff involvement details, if any, insurance/Takaful and other mitigants available, loss estimated for the Licensee and the counterparty, identified gaps in the Licensee and future plan, including staff / customer awareness enhancement programs, and any other observations.

5.3.5.2 These reports shall be followed up for prompt updates viz. outcome of detailed investigation within specified time and those from Royal Oman Police till such time the case is closed diligently. Whatever details cannot be submitted in initial reports should be provided in updates.

5.3.5.3 Material attempts of frauds, likely to be of larger concern, shall also be reported suitably within seven days of occurrence. Attempts not being successful should not stand in the way of due review, care and vigil by the Licensee in the future.

5.3.5.4 Licensees shall arrange to send to the Central Bank copies of the quarterly review reports of the management and half yearly reports of the Board not later than two months / three months respectively, from the end of the respective periods of coverage along with significant observations of reviewing authorities.

5.3.5.5 The copies of quarterly review reports should indicate the numbers of frauds occurred during the period under review and of frauds of the past remaining unresolved / open (the latter with reasons).

5.3.5.6 Licensees being subjected to larger or continued high incidence of frauds shall submit detailed explanations / proposed plan of action to address the underlying issues.
5.3.6 The compliance function should assume responsibility of accuracy and promptness of reports in particular. Internal audit should ensure independent review and report to the Board.
6. **Retention of Bank Records and Documents**

6.1 **Applicable Laws**

6.1.1 All registration documents

6.1.1.1 Commercial Registration Certificate, specimen signature forms, Chamber of Commerce and Industry Certificate etc. must be kept safely until they have expired and a new document / certificate issued in their place.

6.1.2 Accounting records

6.1.2.1 For the purposes of taxation, there is a requirement to keep all registers and documentation for a period of not less than 10 years following the accounting period to which such registers and documents relate.

6.1.3 Contracts of employment

6.1.3.1 Licensees must keep employment records for a period of two years following termination or expiry of the same, since an action can be brought against the Licensee by an employee within this period (Article 5 of the Labour Law).

6.1.4 Actions / proceedings

6.1.4.1 General commercial obligations are binding for a period of 10 years from the date of performance of such obligations, unless the law provides for a shorter period. This means that the normal limitation period is 10 years, and is therefore feasible that a Licensee would have to produce documentation going back 10 years to support any litigation in which it was involved (Article 92 of the Oman Commercial Law).

6.1.5 Limitation period for Bills of Exchange

6.1.5.1 Limitation period for Bills of Exchange is governed by Article 514 of the Oman Commercial Law which stipulates as follows:

6.1.5.2 Every action against the acceptor of a bill of exchange and arising therefrom becomes proscribed on the expiry of three years from the date of maturity.

6.1.5.3 Actions by the bearer against the endorsers or drawer become barred on the expiry of a year from the date of protest made by the legal deadline or from the maturity date if the bill contained a clause exempting from protest.

6.1.5.4 Actions by some endorsers against others or against the drawer become proscribed on the expiry of six months from the day on which the endorser paid the bill or from the day on which the action was brought against him.
6.1.6 Limitation period for cheques

6.1.6.1 Limitation period for cheques is governed by Article 561 of the Oman Commercial Law which stipulates as follows:

6.1.6.2 Actions by the bearer for recourse to the drawee, drawer, endorser and obligors become barred on the lapse of six months from the date of expiry of the deadline for presentation of a cheque.

6.1.6.3 Actions for recourse against each other by all persons obliged to meet the cheque shall become barred on the lapse of one year from the day on which a legal claim is made against him.

6.1.6.4 Respondents must, irrespective of the expiry of the limitation period, declare under oath that they are free of the debt if so requested, and their heirs and other successors must swear that they were unaware that their testator died with his financial obligations encumbered with the debt.

6.1.7 Bank statements

6.1.7.1 Licensees’ actions relating to a mistake or omission in bank statements will lapse six months from the date of receipt of the statement of account (as per Article 414 of the Oman Commercial Law).

6.1.8 In all instances the limitation period for any action pertaining to a current account shall be five years. Such period shall apply from the date when the account was closed.

6.1.9 It may be noted that under the Law of Combating Money Laundering and Terrorism Financing and its Executive Regulations, the minimum retention period prescribed is ten years.

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1 BDD/CBS/CB/ME/NBFC/2009/7449
2 BDD/CBS/CB/ME/NBFC/2003/4935
3 BDD/CBS/CB/2004/1260
TITLE 9: LIQUIDITY RISK

Islamic Banking Regulatory Framework
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1. **General Rules and Guidance**

1.1 **Definition and Profiles of Liquidity Risk**

1.1.1 Liquidity risk is the potential loss to the Licensees arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

1.1.2 Liquidity risk can be categorised into two major types: funding and market liquidity risk.

1.1.3 Funding liquidity risk is the risk that the Licensee will not be able to meet efficiently both its expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the Licensee.

1.1.4 Market liquidity risk is the risk that a Licensee cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.

1.1.5 Licensees have various kinds of obligations, such as requirements to repay current account holders on demand, to provide committed funds in Musharaka transactions, or to make available cash flows for expenses or profit payments.

1.1.6 Licensees solicit and attract various sources of funds to channel to their financing and investment activities. There are two major types of fund providers: (a) current account holders; and (b) unrestricted Investment Account holders (“IAHs”). These account holders require a degree of liquidity to be maintained by the Licensees to meet their requirements for withdrawals.

1.1.7 Licensees may happen to rely heavily on funds provided by current account holders. Repayment by the Licensees of the principal amounts deposited by current account holders is guaranteed without any rights to share in profits, as the current account holders do not share in the risks of the Licensees. A sound repayment capacity is required to meet fully the cash withdrawal requests of current account holders as and when they arise.

1.1.8 Unrestricted IAHs are investors who participate in the uncertainties of Licensees’ business; therefore, they share in profits and bear losses arising from investments made on their behalf, to the extent of their share. Apart from general withdrawal needs, the withdrawals made by IAHs may be the result of (a) lower than expected or acceptable rates of return; (b) concerns about the financial condition of the Licensee; and (c) actual or perceived non-compliance by the Licensee with Shari’a
rules and principles in various contracts and activities. Subject to contractual conditions, restricted IAHs (while not fund providers) may also give rise to liquidity management considerations, in so far as the Licensee may need to replace funds withdrawn by an investor pending realisation of the related assets.

1.1.9 Where the Mudaraba contract is employed to source the funds, from an asset-liability management perspective, the Licensee may be viewed as being hedged to the extent that the IAHs bear the risks of the assets in which their funds are invested. This statement is true only if the Mudarib (Licensee as manager) has acted in accordance with its fiduciary duties under the Mudaraba contract and without misconduct or negligence. IAHs do not share in the risks on assets financed by current accounts, which are borne by shareholders alone.

1.1.10 As fiduciary agents, the Licensees are concerned with matching their investment policies with IAHs’ and shareholders’ risk appetites. If these investment policies are not consistent with the expectations and risk appetites of IAHs, the latter may withdraw their funds leading to a liquidity crisis for the Licensee. This applies particularly to unrestricted IAHs.

1.1.11 This Title sets out rules and guidance pertaining to liquidity risks, highlighting the key elements for effective liquidity management within the scope of Licensees’ exposures.

1.2 Liquidity Management Framework

1.2.1 A Licensee should have in place a sound and comprehensive liquidity risk management framework, integrated into its enterprise risk process, in order to maintain sufficient liquidity to meet its daily funding needs and to cover both expected and unexpected deviations from normal operations for a reasonable time.

1.2.2 The Licensee should have an appropriate governance process, including board and senior management oversight, in order to identify, measure, monitor report and control the liquidity risk in compliance with Shari’a rules and principles and within the context of available Shari’a-compliant products and markets.

1.2.3 Liquidity planning is an important facet of risk management framework in banks. A Licensee has adequate liquidity when sufficient funds can be raised, either by increasing liabilities or converting assets, promptly and at a reasonable cost. It encompasses the potential sale of liquid assets, capital and forex markets.

1.2.4 Licensees shall ensure that their liquidity management framework is compliant with Shari’a guidelines. Licensees should set their liquidity risk
1.2.5 Licensees shall maintain adequate liquidity to meet their obligations at all times. In this regard and taking into consideration the nature of the Licensee, their business activities and the capital market environment, the Licensee shall have in place liquidity management policies, which shall be reviewed periodically, covering:

1.2.5.1 Strategy for managing liquidity involving effective Board of Directors (Board or BoD) and senior management oversight;

1.2.5.2 A framework for developing and implementing sound processes for measuring and controlling liquidity;

1.2.5.3 Adequate systems in place for monitoring and reporting liquidity exposures on a periodic basis;

1.2.5.4 Adequate funding capacity, with particular reference to the willingness and ability of shareholders to provide additional capital when necessary;

1.2.5.5 Access to liquidity through fixed asset realizations and arrangements such as sale and lease-back; and

1.2.5.6 Liquidity crisis management.

1.2.6 The policies shall incorporate both quantitative and qualitative factors. Quantitative factors include the extent of diversity and sources of funds, concentration of the funding base, reliance on marketable assets and availability of standby lines of external funding. Qualitative factors include assessing the general ability of the management, the particular skills in treasury management and public relations, the quality of Management Information Systems (“MIS”), Licensees’ reputation in the market, the willingness and ability of shareholders to provide additional capital and, in the case of a window, branch or subsidiary, the willingness and ability of the head office or parent to provide liquidity.

1.2.7 To ensure liquidity management at Islamic Windows, the parent conventional bank may enter into a subordinate agreement (internal commitment) to supply emergency funds to the Islamic Window under a Shari’a compliant contract structure.

1.2.8 Islamic window can receive money from its parent in case of real need in any of the following ways: (a) permanent capital increase (by increasing the limit of capital allocation) (b) interest free loan for a specified period (c)
Inter-bank Musharaka or Mudaraba for a specified period no more than six months. The Liquidity Management Policy of all Licensees shall allow for the same for sound liquidity management of the Islamic Windows.

1.2.9 Licensees are not allowed to place funds with conventional banks. Also the Islamic Windows are not allowed to place funds with their parent bank.

1.2.10 Islamic Banks can receive money from conventional banks as long as the underlying contract is Shari’a compliant. Similarly, Islamic Windows can receive money from their conventional parent under a Shari’a compliant contract structure.

1.2.11 The strategy and policies for liquidity risk management should explicitly incorporate both normal and stressed times.

1.2.12 In the case of a liquidity stress – whether idiosyncratic or market-wide – a Licensee may face problems in obtaining medium- to long-term funding due to loss of confidence by the market players and other fund providers. In addition, time horizons of current financing may shorten because payment obligations will fall due earlier than the historical practice. In such times, Shari’a compliant contracts held by a Licensee, which are already facing the problem of low market depth, may become non-saleable. Therefore, the board should clearly set out in its liquidity risk management framework the degree of reliance on liquidity buffer and committed lines of financing, fully reflecting the trade-off between cost and resilience to liquidity stress.

1.2.13 The Board should clearly distinguish between service (or cost) centres and profit centres while formulating the policies of liquidity risk management at the Licensee. Further, liquidity risk management strategy and policies should cover the short-term and long-term liquidity needs, as well as off-balance sheet and contingent liquidity risks.

1.2.14 Licensee should perform an impact analysis on management and mitigation of liquidity risks arising from new business initiatives and product approvals. This analysis should be performed by competent professionals from the relevant departments and functions.

1.2.15 Licensee should consider liquidity needs and constraints while preparing business plan, future capital raising, allocating capital buffers, etc.

1.2.16 Licensee should have comprehensive and appropriate internal controls and internal audit mechanisms, in order to evaluate and test the adequacy of controls in the liquidity risk management framework. Since most of the activities performed by various functions of the Licensee can have an
impact on its liquidity risk and level of liquidity, liquidity risk management strategy and policies should be communicated throughout the institution. The senior management should ensure that all such functions and business units are operating under the approved policies, procedures and limits.

1.3 Role of the Board of Directors

1.3.1 The Board of Directors has the ultimate responsibility for setting the level of liquidity risk to be incurred (the liquidity risk tolerance) and the liquidity risk management framework of the Licensee. It should establish a level of liquidity risk tolerance for the Licensee commensurate with its ability to have sufficient recourse to Shari’a-compliant funds in order to mitigate this risk. In line with the stated risk tolerance, the Board should establish, approve and review from time to time the liquidity risk management strategy and significant policies.

1.3.2 The Board should establish lines of authority and responsibility for various board committees and senior management in order to manage liquidity risk in the Licensee. If the Board delegates to certain board committees authority for approving various policies, procedures and limits, it should clearly set out the roles, functions and scope of work of those committees. The Board should also ensure that senior management transforms Board-approved strategies and policies into detailed and well-documented guidance, procedures and operating instructions which are properly aligned from risk and reward perspectives.

1.3.3 The Board should review the compensation structure of senior management to ensure ownership and alignment of risk in the Licensee’s various activities. The Board should also approve and review the Licensee’s liquidity Contingency Funding Plan (CFP) for handling institution-specific or market-wide liquidity stress to ensure that the Licensee continues to fund its important activities on a timely basis, without incurring unacceptable costs or losses.

1.3.4 The Board should critically review all liquidity related reports submitted by the management of the Licensee.

1.3.5 The Board should ensure that timely remedial action is taken by senior management to address these issues and developments that can impact the liquidity profile of the Bank. The Board should conduct self assessment of
its monitoring of liquidity risk and should be proactive in seeking additional detailed information from relevant bodies in case of need.

1.4 **Role of Senior Management**

1.4.1 The governance structure of the Licensee should outline the roles and responsibilities of senior management, the Shari’a Supervisory Board, as well as various functional and business units, including those of the risk management department, with appropriate segregation between operational and monitoring functions.

1.4.2 The senior management of the Licensee has responsibility for executing the liquidity risk management strategy and policies approved by the Board in an integrated manner, while ensuring that liquidity is effectively managed on a regular and timely basis and that appropriate policies and procedures are established to limit and control material sources of liquidity risk.

1.4.3 ALCO or any other committee assigned to monitor liquidity risk should actively monitor its liquidity risk profile and should have adequate broad representation within the institution, including finance, treasury, senior managers, credit, deposits and investments, financing and risk management.

1.4.4 The Board should define the mandate of this committee in terms of planning, directing and controlling the flow, level, mix, cost and yield of the Licensee funds and investments.

1.4.5 Senior management should be able to respond to all the material liquidity risk related developments and report to the Board, where applicable, in a timely manner. It is the responsibility of senior management to ensure that adequate internal controls and internal audit mechanisms are in place to protect the integrity of the established liquidity risk management process.

1.4.6 The responsibility lies with senior management to appoint skilled and capable personnel who understand the nature and peculiarities of Shari’a-compliant contracts and products to handle the liquidity risk management and internal control functions.

1.4.7 Senior management should keep a constant eye on changes in market conditions and new developments that can present significant challenges in terms of the smooth management of liquidity risk in the Licensee.

1.4.8 Senior management should periodically report the key highlights of liquidity risk management to the Board.
1.5 Identification of Liquidity Risk

1.5.1 A Licensee should be able to identify all sources of primary and secondary risks – whether idiosyncratic or market-wide – that can lead to and interact with its liquidity risk.

1.5.2 The Licensee should be able to model the contractual as well as the behavioural profiles of its investment account holders (IAHs) – especially unrestricted IAHs – current and savings account holders and other fund providers, in normal and stressed market conditions. In doing so, the Licensee should take account of the effects of any smoothing practices it has adopted in making profit payouts to its IAHs, and its possible access to Shari’ a-compliant Takaful arrangements.

1.5.3 A Licensee should be able to identify the liquidity risk it is exposed to, in the short and long term, arising from institution-specific or market-wide events for all its operations including subsidiaries, branches, or similar arrangements. In the process of identification, the Licensee should identify and recognise each significant on- and off-balance sheet position that can have an impact on its liquidity in normal and stressed times and establish a range of metrics.

1.5.4 The Licensee should consider the types of events that can expose it to liquidity risk. It should have a robust framework for projecting the contingent liabilities and other commitments, including calculating the impact of drawing on undrawn commitments. The identification process should consider the nature of exposure, the creditworthiness of the counterparty, correlations between the various business and geographical sectors, and the nature of the relationship with counterparties. A Licensee should be able to identify incidents that can negatively influence its perception in the marketplace about creditworthiness and fulfilment of its obligations.

1.5.5 The Licensee should take into account that liquidity risk is often considered a subsequent or secondary risk arising out of credit, market or operational risk events. Therefore, liquidity risk may be understood from the perspective of a consequential risk. Liquidity risk can also arise due to failure or weaknesses in business decisions and corporate policies, including shortcomings in business strategy, modelling assumptions and the Licensee’s communication in a period of stress. In the process of
identification, the range of assumptions used in predicting the timing and volume of cash flows is also important.

1.5.6 Licensees should ensure that their core banking systems and other related IT systems recording information relevant to liquidity risk management are appropriate and meet the Shari’a requirement. The systems should be able to distinguish Shari’a compliant funds, identify concentration of funding sources, record sources of funds, maturity profile of funds, demographic details of fund providers, behavioural data of fund providers and other information required for operation and analysis of liquidity risk management.

1.6 **Measuring and Monitoring Liquidity**

1.6.1 Measuring and managing liquidity needs are vital for effective operation of the Licensees. By assuring a Licensee’s ability to fund asset growth and meet its obligations as they come due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have impact on the entire system.

1.6.2 A Licensee’s management shall measure not only the liquidity positions of the Licensee on an ongoing basis but also examine how liquidity requirements are likely to evolve under different scenarios.

1.6.3 Licensees should simulate stress scenarios and measure their liquidity requirements during these scenarios. The simulation of stress scenarios should consider specific features of Islamic banking, global and local macroeconomic factors.

1.6.4 *Liquidity measurement can be done through either stock or cash flow approaches. Under the stock approach, liquidity is measured in terms of ratios, which portray the liquidity stored in the balance sheet. The key ratios generally used across the banking system are:*

   1.6.4.1 *Net Financing to Total Assets.*
   1.6.4.2 *Financing to Customer Deposits.*
   1.6.4.3 *Liquid Assets to Short-Term Liabilities.*
   1.6.4.4 *Large Liabilities (minus) Temporary Investments to Earning Assets (minus) Temporary Investments, where large liabilities represent wholesale deposits which are market sensitive; temporary investments are those maturing within one year*
and those investments which are held in the trading book and are readily saleable in the market.

1.6.4.5 Purchased Funds to Total Assets, where purchased funds include the entire inter-bank and other money market financing, including Certificates of Deposits and institutional deposits.

1.6.4.6 Commitments to Total Financing, where the commitments are in the nature of LCs, Guarantees and Acceptances.

1.6.5 While the liquidity ratios are the ideal indicator of liquidity of banks operating in developed financial markets, the ratios do not reveal the intrinsic liquidity profile of the financial institutions operating in an illiquid market/times which are/or may turn to be illiquid. Thus, analysis of liquidity involves tracking of cash flow mismatches. For measuring and managing net funding requirements, the use of maturity ladder and calculation of cumulative surplus or deficit of funds at selected time bands is recommended as a standard tool. The Licensees can also estimate the liquidity profile in a dynamic way by giving due importance to seasonal pattern of existing deposits/financings and potential liquidity needs for meeting new financing demands, commitments, potential deposit losses, investment plans, statutory obligations, etc.

1.6.6 For prudential purposes, the Licensees shall measure cash flows on a static basis. The dynamic profile is limited for planning purposes.

1.6.7 The maturity profile shall be used for measuring the future cash flows of Licensees in different time bands. The time bands are distributed as under:

1.6.7.1 Upto one month
1.6.7.2 Over one month and upto 3 months
1.6.7.3 Over 3 months and upto 6 months
1.6.7.4 Over 6 months and upto 9 months
1.6.7.5 Over 9 months and upto 1 year
1.6.7.6 Over 1 year and upto 3 years
1.6.7.7 Over 3 years and upto 5 years
1.6.7.8 Over 5 years

1.6.8 The statement of Maturity of Assets and Liabilities (“MAL”) should be prepared by placing all cash inflows and outflows in the time bands according to the residual term to maturity.
1.6.9 However, some of the assets and liability items lack any definite contractual maturity like investments in Musharaka, current deposits, etc. Thus, while determining the likely cash inflows / outflows, Licensees have to make a number of assumptions according to the behaviour of assets and liabilities.

1.6.10 The Licensees shall have their own criteria for classifying cash flows, including behavioural methods, and may consider differentiating the types of cash flows as indicated below:

1.6.10.1 Known cash flows – the maturities and the amounts are known in advance. This category includes receivables from Murabaha, Ijarah, IMB receivables and Diminishing Musharaka.

1.6.10.2 Conditional but predictable cash flows (Salam and Istisna’a) – conditionality is defined in terms of the type of contract or performance of work based on the agreed terms and conditions over an agreed period.

1.6.10.3 Conditional and unpredictable cash flows – for instance, an investment in a Musharaka is for an open-ended period and an exit strategy may be assessed periodically. The redemption of invested capital and possible levels of return on investment are conditional upon the performance of the activities.

1.6.11 The cash flows shall be placed in different time bands based on future behaviour of assets and liabilities. In other words, Licensees should have to analyse the behavioural maturity profile of various components of balance sheet items on the basis of assumptions and trend analysis supported by time series analysis.

1.6.12 The Net Funding Requirements (“NFR”) is the difference between cash inflows and outflows in each time band. This excess or deficit of funds becomes a starting point for a measure of a Licensee’s future liquidity surplus or deficit, at a series of points of time. Within each time band there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on mismatches up to three months.

1.6.13 While the basis of an NFR calculation is to assume that the funds are repaid at the contractual maturity date, it may not be realistic to assume that all IAHs will maintain their funds at the Licensee until maturity. Therefore, an internal assessment of their expectations will be part of an NFR calculation.
1.6.14 Licensees, who are reliant on short-term funding, should, however, concentrate primarily on managing their liquidity in the very short-term horizons and preferably on a day-to-day basis.

1.6.15 Due to Licensees’ dual role in meeting their obligations to current account holders and managing the expectations of their IAHs, the Licensees should make periodical cash flow analyses (preferably quarterly, more frequently when needed) under various market scenarios and conditions for the purpose of planning. The scenarios may vary, depending on local market conditions, and may be based on (a) a “normal” operating environment (e.g. a steady state condition); and (b) scenarios of adverse circumstances (e.g. non-linear events and chaotic conditions). For example:

1.6.15.1 The analysis should include assumptions about the repayment of invested capital to the IAHs. In the event of investment losses, the extent to which the losses will be mitigated by the use of the Investment Risk Reserve (“IRR”) needs to be considered.

1.6.15.2 The scenarios should be based on relevant assumptions based on factors affecting the Licensees’ on- and off-balance sheet exposures. Liquidity levels and early withdrawal profiles computed under these scenarios should be back-tested periodically to validate the underlying assumptions of the measurement process.

1.6.15.3 In analyses based on behavioral assumptions and scenarios, Licensees will assess and apply the liquidity measures that reflect the specificities of each portfolio. The size and characteristics of the assets, which Licensees hold in relation to the restricted investment portfolios, will determine their specific liquidity profiles.

1.6.16 Licensees shall maintain cumulative liquidity mismatches within 15% of the total cumulative liabilities (outflows) in the first five time bands of each currency.

1.6.17 Licensees may monitor their liquidity exposures separately according to the nature and mix of their fund providers – current account holders and unrestricted IAHs, which can be expected to vary substantially. The effects of liquidity shortages may vary according to the fund providers’ liquidity preferences; hence, separate limits on liquidity mismatches should be set up accordingly. These limits should be regularly reviewed, taking into account the Licensees’ liquidity situation, economic climate and market conditions.

1.6.18 The liquidity position shall be measured in all major currencies in which the Licensees deal on individual and aggregate levels.
1.6.19 An internal fund transfer pricing (FTP) technique is being used by some large conventional banking institutions. It is an important tool for measurement and analysis of pricing, profitability and performance of various business lines, products and branches within the bank. Keeping in view the nature of such techniques, the objectivity and impartiality of the function performing this task, Licensee should migrate to such techniques in due course of time.

1.7 Liquidity Risk Mitigation

1.7.1 Liquidity management for the Licensees as a market is not tested in the Sultanate and there are no past events or record to guide the Licensees. Licensees should apply greater care and conservatism especially during the initial years. Maintenance of buffer, contingency planning, scenario analysis, stress testing etc. should be done keeping this in mind.

1.7.2 Liquidity management framework of Islamic Windows should take into consideration the overall liquidity management framework of the conventional parent.

1.7.3 Licensees shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shari’a compliant funds to mitigate such risk.

1.7.4 Licensees shall maintain 5% of their deposits including unrestricted URIA but excluding RIA as cash reserve in interest free deposits with the Central Bank.

1.7.5 Licensees shall finance by asset products only up to 87.5% of its deposits base. The deposit base for the purpose of calculation of financing ratio shall include own funds, net funds from banks abroad, deposits exclusive of RIA and local inter-bank.

1.7.6 The Central Bank shall periodically review provisions under Articles 1.7.4 and 1.7.5 and may amend these ratios in line with the change in systemic risk, finance/liquidity in the market and other considerations as deemed necessary.

1.7.7 Licensees shall assess the necessity and extent of their access to available funding sources. In managing their liquidity, Licensees have the following possible funding sources: natural cash flows arising from their usual banking activities, the realisation of tradable invested assets, asset securitisation and their capacity to access shareholders’ and / or head office funds.
1.7.8 Licensees’ liquidity management policies shall include some form of contractually agreed orderly liquidation procedures to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the IAHs funds and damage to the Licensees’ reputation and viability.

1.7.9 Licensees must have a liquidity contingency plan addressing various stages of a liquidity crisis. Licensees should define the classification of these stages but may consider differentiating the stages as follows:

1.7.9.1 Identification of a liquidity gap or a situation which acts as a triggering event where withdrawals do not follow predictable patterns when, for example, the Licensees may suffer an institutional rating downgrade;

1.7.9.2 A need to liquidate assets or investments in an orderly manner to meet such a liquidity gap or situation; and

1.7.9.3 Emergency measures to be taken in the event that the previous steps fail to meet the liquidity gap adequately.

1.7.10 Where appropriate, Licensees shall include in their contingency plans the following factors and define appropriate action points at each stage:

1.7.10.1 Holdings of tradable high quality liquid assets, which may be readily disposed of in sizeable amounts in deep markets taking into account the likelihood that it will not be possible to realise full book value;

1.7.10.2 Profile of other assets and the degree of liquidity of these assets;

1.7.10.3 Assessment of Shari’a-compliant and available funding products in the market including possible cooperation agreements with other Licensees or conventional institutions on an interest-free basis for accessing temporary funding, or sale and leaseback arrangements for longer term funding;

1.7.10.4 Possible liquidity arrangements with the Central Bank (on a Shari’a compliant basis);

1.7.10.5 Establishment of a crisis management team or personnel responsible for taking actions at different stages of the liquidity crisis; and

1.7.10.6 Notification procedures for communication with Licensees’ head office and / or the Central Bank.

1.7.11 However, to the extent that Licensees intend to rely on the types of cooperation agreements mentioned above, they need to ensure that willing counterparties will exist for such arrangements.
1.7.12 Licensees should prepare Contingency Plans to measure their ability to withstand bank-specific or market crisis scenario.

1.7.12.1 Estimating liquidity under bank-specific crisis scenario should provide a worst-case benchmark. It should be assumed that the purchased funds could not be easily rolled over; some of the liabilities could be prematurely closed; a substantial share of assets has turned into non-performing and thus become totally illiquid. These developments would lead to ratings downgrade and high cost of liquidity and constricted access to money / forex market. The Licensees should evolve contingency plans to overcome such situations.

1.7.12.2 The market crisis scenario analyses cases of extreme tightening of liquidity conditions arising out of monetary policy stance of the Central Bank, macro-economic conditions, general perception about risk profile of the banking system, severe market disruptions, failure of one or more of major players in the market, financial crisis, contagion, etc. Under this scenario, the rollover of high value customer deposits and purchased funds could be extremely difficult besides flight of volatile deposits / liabilities. The Licensees could generate liquidity by unwinding their investment positions only with huge capital loss.

1.8 Foreign Exchange Liquidity Risk

1.8.1 Licensees should have a measurement, monitoring and control mechanism for liquidity positions in each currency with a significant exposure. Licensees should indentify, measure, monitor and, where appropriate, limit the size of its cash-flow mismatches over particular time horizons for foreign currencies in aggregate and for each significant individual currency in which it operates, especially with respect to its domestic currency (or, where different, its functional currency).

1.8.2 Licensees should employ appropriate stress tests and make use of Shari’a compliant hedging strategies (as approved by their respective SSBs) for limit setting and controlling currency risk. Licensee should especially limit its exposures in currencies that are not highly liquid or have low convertibility.

1.9 Liquidity Buffer

1.9.1 Licensees should maintain a liquidity buffer, composed of cash and other highly liquid Shari’a compliant assets, in order to withstand a prolonged period of potential stress conditions.
1.9.2 There should be minimal legal, regulatory or operational obstacles to the sale or pledge of such assets in order to generate funding in a variety of market stress situations.

1.9.3 The magnitude and composition of these assets should be in line with the risk tolerance, decided by its Board, and its liquidity requirements as estimated by its stress testing exercises.

1.9.4 Licensees should calibrate the magnitude of their liquidity buffer on the basis of their funding gap and stress testing exercise over specific time horizons. The calibration of a liquidity buffer is highly dependent on assumptions used for defining the stress conditions. These assumptions incorporate the factors such as net and cumulative funding requirements in various time buckets, as well as encompassing both contractual and non-contractual cash flows. Assumptions should also include factors such as the length and severity of stress, the withdrawal of funding by IAHs and depositors, and the non-availability of funding on an unsecured basis as well as on a secured basis from modestly liquid assets.

1.9.5 The Board and senior management of the Licensee should try to balance the “cost” of maintaining a liquidity buffer with the “benefit” in terms of better ability to meet any contingency due to its presence. A bigger liquidity buffer that is not justifiable by the risk tolerance of the Licensee can impact its financing ability, raise the cost of financing, and might lead to reduced economic activity.

1.9.6 Licensees should consider maintaining a liquidity buffer to cover three phases of stress. In the first phase, the buffer should be sufficient to meet the liquidity requirements for severe market stress lasting one to two weeks. In the second phase, the buffer should be able to endure a less severe stress of two to eight weeks. In the third phase of persistent liquidity problems, a Licensee’s CFP should become operational and measures should be taken according to pre-planned steps. In this stage, a Licensee may also consider more strategic steps, such as a change in business model or readjusting the balance sheet portfolio.

1.9.7 Licensees should also test and be reasonably active in each market in which they keep Shari’a compliant assets as liquidity buffers. This will provide an assurance to the Licensees about the liquidity of such products in various market conditions and will provide an opportunity to test their assumptions. It will also reduce the potentially adverse reputational effects that can result from being active in the market in difficult times, and sending the wrong
market signals about the condition of its liquidity, financial condition and soundness to various stakeholders.

1.10 Liquidity Risk Management within a Banking Group

1.10.1 A Licensee as part of a financial group (e.g. a full-fledged Islamic bank or an Islamic window operation) which has a centralised structure for managing liquidity risk, the board and senior management at the group/parent level should prepare a strategy, policies and procedures for the Islamic banking operations taking into account the position of such operations within the overall group/parent, with due consideration to independence and constraints in transfers of liquidity on a Shari’a compliant basis between the group entities.

1.10.2 A major concern in centralised liquidity risk management structures is the transfer of liquidity from an Islamic entity to the conventional group/head office, which is not permissible as per the Central Bank rules. However, liquidity can be transferred from conventional group/head office to the Islamic Window if the issues of segregation of funds, regulatory constraints on any such transfer and the use of Shari’a compliant structures or contracts are appropriately addressed.

1.10.3 Licensees should develop such Shari’a compliant structures which allow placement of funds, if needed, from conventional group/head office to the Licensees. Such structures should be duly approved by the respective SSBs. Such structures should address all Shari’a considerations including commingling of funds, payment of profit, etc.

1.10.4 Liquidity risk identification, measurement and monitoring should be carried out separately for Islamic banking operations.

1.10.5 Each Licensee should develop its own unique stress scenarios and contingency planning. Such plans should consider potential stress scenarios caused by internal and external factors.
2. Islamic Contracts for Generating Liquidity and Investing Surplus Funds

2.1 Introduction

2.1.1 The Islamic money market is integral to the functioning of the Islamic banking system, firstly, in providing the Islamic financial institutions with the facility for funding and adjusting portfolios over the short-term, and secondly, serving as a channel for the transmission of monetary policy. Financial contracts and interbank investment would allow surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system.

2.1.2 To operate in Islamic Interbank Money Market, the Licensees may use several contracts such as Mudaraba Interbank Investments, Government Investment Issues (Sukuk), Commodity Murabaha Transaction, etc. Mudaraba Interbank Investment is one of the standardised products and one of the commonly used contract instrument in the Interbank Money Markets.

2.1.3 The following sections briefly describe select common contracts used. The guidelines highlighted in Article 2.2 should only be considered as broad enabling provisions. Licensees should seek guidance and approval from their respective SSBs before any such products are launched. The section also highlights certain market wide initiatives. Such provisions shall be operative when related authorizations and details regarding legal, regulatory, operational, economic and other considerations are fulfilled.

2.2 Interbank Mudaraba

2.2.1 Interbank Mudaraba is one of the most commonly used products by Islamic Banks in a number of jurisdictions. Interbank Mudaraba investments are usually short-term in nature, with the profit-sharing ratio being negotiated between the parties. It is a low-cost but non-tradable instrument. The negotiated profit-sharing ratio is commonly fixed to achieve the target return that the investing financial institution is seeking from its investments, keeping in view the income generated in previous periods by various investment pools (general or specific) maintained by the Licensee receiving the funds.

2.2.2 Income smoothing techniques used for retail and small business investment accounts are largely not used in the case of interbank Mudaraba-based investment
accounts. Nevertheless, the counterparty risk remains in such transactions because it is a non-collateralised transaction.

2.2.3 Excess can be placed and deficit funds may be sourced through Mudaraba based interbank acceptance or placements.

2.2.4 Specific Investment Pools are created by a licensee for acceptance of funds under Interbank Mudaraba. These pools comprise of financing assets like Murabaha, Ijarah etc (ideally tangible assets) created to meet the short-term liquidity requirements of the bank.

2.2.5 At maturity, normally these Investment Pools are dissolved and assets are transferred back to other investment pools.

2.2.6 The pool must comprise of significant portion (min 10%) of fixed / tangible assets (like Ijarah or fixed asset Musharaka etc) to make redemption possible.

2.2.7 The tenure of this Investment Pool must be less than or equal to the tenure of the financing assets in the Pool.

2.2.8 The Investment Pools are given a unique Pool Identification Number (PIN) at the time of pool creation. This PIN is used for asset allocation, deal confirmation and other related accounting purpose.

2.2.9 The proper allocation of financing assets implies that related risk and reward (Profit or Return) of the asset are clearly linked to a specific Investment Pool.

2.2.10 Licensees are allowed to use Mudaraba Interbank Investment for effective management of their liquidity position.

2.2.11 The principal invested shall be repaid at the end of the period, together with a share of the profit arising from the use of the fund by the investee bank. Losses, if any, are shared on pro-rata basis (in ratio of the investment shares of both the parties).

2.2.12 The time period of investment shall be within overnight to 12 months.

2.2.13 The rate of return shall be based on the rate of gross profit before distribution. The investor bank at the time of negotiation would not know what the return would be, as the actual return will be crystallised towards the end of the investment period, based on the gross profit in the underlying and the agreed profit sharing ratio.
2.2.14 A Licensee receiving the funds through such an investment should clearly set out the agreed-upon profit-sharing ratios and treatment of funds in the case of loss, including any techniques used for covering the loss, such as Investment Risk Reserve (IRR).

2.3 **Interbank Musharaka**

2.3.1 *Interbank Musharaka is similar to Interbank Mudaraba contracts. Investments are usually short-term in nature, with the profit-sharing ratio being negotiated between the parties. It is also a low-cost but non-tradable instrument. The negotiated profit-sharing ratio is commonly fixed to achieve the target return that the investing financial institution is seeking from its investments, keeping in view the income generated in previous periods by various investment pools (general or specific) maintained by the Licensee receiving the funds.*

2.3.2 *The funds are placed or borrowed by a Licensee and invested in for investment in a pool of assets on Musharaka ('Shirkat-ul-Aqd') basis. Such pools are special purpose investment pools, comprising of Shari’a-compliant financing assets (e.g. Murabaha, Ijarah, DM etc.), created to meet the short-term liquidity requirement. At maturity, normally these pools are dissolved and the assets are transferred back to other pool(s).*

2.4 **Interbank Wakala Placement and Acceptance**

2.4.1 *Wakala is an investment management contract where the investor agrees to provide the Licensee with funds to invest in different assets. The Licensee would be, in effect, the investor’s agent and will be paid a fee for its services, while the investor receives the returns. It entails lower transaction costs due to the non-involvement of a broker, but it tends to be more risky due to the counterparty exposure and its uncollateralised nature. It is also a non-tradable and over-the-counter transaction where market makers are not available.*

2.4.1.1 *If the Wakeel performs the assigned duties against a consideration (fee, incentive, commission etc.) for its services, the Wakala would be a 'Remunerative Wakala'. Remunerative Wakala is a binding contract on both the parties. Therefore, it cannot be revoked unilaterally.*

2.4.1.2 *If the Wakeel performs the assigned duties without any consideration (i.e. fee, incentive, commission etc.) for its services, the Wakala would be a 'Non-Remunerative Wakala'. Non-remunerative Wakala is a non-binding contract and*
can be revoked any time by any of the parties, only by serving a notice to this effect. However, it can be a binding contract if the parties so agree.

2.4.2 Similarly, a Licensee can place excess funds on a Wakala basis with similar Islamic financial institutions.

2.4.3 Licensees should be aware that their Wakala-based placements may be quite volatile in case of any concern about the Licensees’ soundness or Shari’a compliance practices.

2.4.4 Licensees should also evaluate the impact of any general market disruption on such placements.

2.4.5 In order to reduce any documentation risk attached to Wakala funds the Licensees should seek to prepare and standardise their contract documentation on the basis of international best practices.

2.5 Commodity Murabaha Transaction

2.5.1 “Commodity” means a physical product which is and can be traded on a secondary market – e.g. agricultural products, minerals (including oil) and precious metals. This includes different types of freely tradable Shari’a permissible commodities (such as platinum, crude palm oil, wheat, cotton, etc.) as approved by the respective SSB of the Licensee.

2.5.2 The scope of the Commodity Murabaha Transaction (CMT) may include those Shari’a compliant commodities that the Licensee buys from the market on the specific request of a customer (which request could take the form of either a binding or a non-binding promise to purchase the subject matter from the Licensee). Alternatively, the Licensee buys Shari’a compliant commodities for sale under the CMT arrangement.

2.5.3 CMT as a tool for liquidity management means a Murabaha based purchase and sale transaction of Shari’a permissible commodities, whether on cash or deferred payment terms. Terms and conditions of the CMT will contain, inter alia: (a) the nature of the transaction; (b) the type and description of the commodities; (c) the quantity of goods, details of the time of payments and the unit price thereof; (d) the purchase price or cost, rate of profit and sale price; (e) the stipulation that delivery of the commodities is certain and unconditional; and (f) the nature of the seller’s ownership of the commodity in terms of period and type of currency before selling it to the counterparties under the CMT.
2.5.4 In CMT, a customer (counterparty) may be the recipient of funds, since the customer (counterparty) purchases the commodity from the Licensee on credit and sells it on spot to a third party to obtain funds. Alternatively, the Licensee may be the recipient of funds, since it buys the commodity from an individual or financial institution on credit and sells it on spot to a third party to obtain funds.

2.5.5 Commodity Murabaha Transaction (“CMT”) or Tawarruq, by whatever name called, is not allowed for the Licensees in the Sultanate as a general rule. The only exception may be a real emergency situation defined as follows: If a Licensee’s survival is genuinely threatened, or in case of a conventional bank’s conversion into Islamic where no other alternative mechanism exists to convert part or all of its portfolio, as determined by the bank’s SSB. In such a situation and on a case to case basis the Central Bank may allow the use of CMT after the approval of the respective Shari’a Supervisory Board on a one-off basis for a specified time period no longer than three months.

2.5.6 Roll over in such CMTs or changing the price is not allowed under any circumstances.
TITLE 10: MISCELLANEOUS

Islamic Banking Regulatory Framework
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1. **Introduction**

1.1.1 This Title attempts to sum up important Banking Law, regulatory and circular provisions of the Central Bank, not covered in earlier Titles and by way of elaborations / clarifications provided.

1.1.2 The contents need to be read in conjunction with other contents accordingly.
2. **Staff Matters**

2.1 **Annual Return on Senior Management**

2.1.1 Licensees should provide a list of senior management incumbents annually (within three months from the closure of the year). There shall be annual review of continued compliance with “fit & proper” criteria for senior management officials and compliance with Omanisation requirements (including need for Omanising the positions) and confirmation to the Central Bank while providing the list. Approval requirements shall also apply to renewal of contracts.\(^1\)

2.1.2 Along with the annual return mentioned above, Licensees shall submit their organisational chart mentioning senior management positions and names of incumbents (Assistant General Manager and above), Heads of Internal Audit, Compliance and Risk Management of domestic Licensees and details of positions held, if any, by senior management incumbents in other companies and exceptional authorisations, if any, provided by the Central Bank.

2.2 **Senior Management Designations**

2.2.1 In order to maintain uniformity and homogeneity of line management, the Licensees shall maintain standard designations like Chief Executive Officer and/or General Manager, Deputy General Manager, Assistant General Manager, etc.\(^2\)

2.3 **Compensation Practices**

2.3.1 The principles, standards and methodology for assessing compliance in important areas of compensation practices provided by FSB and BIS papers call for effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation.\(^3\) Licensees are expected to study them and consider the need for any appropriate revision in the compensation framework accordingly.

2.4 **Omanisation**

2.4.1 Pursuant to the official directives from higher authorities in the government regarding recruitment and training of Omani nationals in the banking field, the Central Bank specifies the following percentages of Omanisation to be maintained by all Licensees at all times\(^4\):
Overall Omanisation ratio: 90%

Sub-segmental Omanisation ratio:

Top and middle management: 75%
Clerical staff: 95%
Non-clerical staff: 100%

2.4.2 Foreign Licensees of small size where the total staff strength is less than 20 have the option of either (1) achieving overall target of 90% together with the job category wise sub-targets of 75% in the top and middle management, 95% in clerical and 100% in non-clerical or (2) having a maximum expatriate staff strength of 3 including the expatriate country head.

2.4.3 Central Bank draws the attention of the Licensees to the undertakings given where the Licensees are committed to take steps which would qualify Omani within a reasonable time frame for managerial positions.  

2.4.4 Licensees should have appropriate strategy and time-bound plans in this regard and these should also cover key senior management positions.

2.4.5 Licensees should have a system of reviewing the performance of all senior staff, including non-Omanis, not only in terms of competence, performance and potential but also their contribution in enhancing the skills and roles of Omani staff working under them.

2.5 Employment of Persons Who Have Residence Permits

2.5.1 It is not permitted for the Licensees to employ persons whose residence visas have been sponsored by others as per Article 105 of the Labour Law. Offenders are liable to the penalties prescribed in Articles 103 and 105 of the same Law. In addition, any offending Licensees will also be liable to sanctions stipulated in the Banking Law 2000 and regulations framed thereunder.
3. Due Diligence

3.1 Due Diligence in Fiduciary Practices

3.1.1 Assets held by a Licensee and obligations incurred in a fiduciary capacity shall not be considered to be assets or obligations of such Licensee.\(^8\)

3.2 Adoption of International Best Practices on Customer Due Diligence

3.2.1 Licensees are advised to evaluate their existing Know Your Customer (KYC) standards in line with the recommendations given in the BIS paper on customer due diligence for banks.\(^9\)

3.3 Constitutive Contracts

3.3.1 Licensees should obtain constitutive contracts and other documents as part of due diligence before establishing any banking relationship.\(^10\)

3.4 Non-Exercise of Voting Rights by Licensees in a Fiduciary Capacity or as an Investment Banker

3.4.1 Licensees shall not exercise voting rights of whatsoever nature in respect of the equity holdings of a bank licensed in Oman and/or its associated parties held by them on behalf of their clients, even when such voting rights are conferred on them by means of proxy or otherwise, in the process of transacting investment banking business.\(^11\)

3.4.2 Licensees holding investment banking license may exercise voting rights on behalf of their clients in respect of their shares in entities other than the above subject to certain operational safeguards (e.g. specific written authority from a client).

3.4.3 Licensees shall maintain arm’s length between their income, expenditure, assets and liabilities and that of their clients while transacting investment banking business both in letter and spirit.

3.5 Freedom of Banking Relationship
3.5.1 No Licensee shall, as a condition of undertaking the transaction of banking business with any person or customer or of continuing to transact banking business with any customer, require any action which would unreasonably preclude such person or customer from being a customer of another Licensee.12

3.6 Inoperative Accounts

3.6.1 Licensees must have a policy, system and procedures to identify inoperative / dormant accounts and which should cover, at a minimum, the period of dormancy which makes an account to attract such a classification, authorization levels / control requirements for reactivation / repayments and processes to follow up appropriate revival / restoration of such accounts to normalcy.13

3.6.2 Running accounts not operated and other balances / accounts not claimed for two years (from due dates of payment) and other amounts not claimed for two years after they are due for payment may be treated as inoperative accounts (although Licensees can set a shorter period as per their internal policy).

3.6.3 Licensees should continue to apply / credit profit on such investment accounts at applicable rates. Similarly, for overdue amounts the Licensees may charge appropriate and reasonable penalty to be given to the charity fund as per the guidance of the Shari’a Supervisory Board.

3.6.4 Licensees must set in place appropriate procedures to contact investment account holders and customers to whom financing has been provided to pursue them to revive / repay.

3.6.5 Licensees should continue to educate the customers on the need and desirability to keep the accounts alive. This should be done on an ongoing basis – at the time of opening accounts, reminders through statements of accounts, display on notice boards and website, etc.

3.6.6 Without undermining customer confidentiality provisions the Licensees should diligently reach out to holders of inactive accounts (and their heirs, as the case may be).

3.6.7 Licensees are not allowed to follow the practice of taking balances in dormant / inoperative accounts to any income account since there is no law of limitation applicable for such accounts and it is not a desirable practice - amounting to undue enrichment.

3.6.8 In respect of other amounts payable (e.g. unclaimed inward remittances, outward remittances returned, etc.) the Licensees should demonstrate the same degree of
diligence in tracing the owners and retaining the amounts in trust in the mean
time.

3.6.9 The top management / management committee and the Board should review
inactive accounts’ details (number of accounts, balances, variances) at least once
a year, involving audit, compliance and quality assurance functions in the
process.

3.6.10 The Central Bank emphasizes the importance of record-keeping in all respects.
The normal limitation of record keeping must not be adhered to as a matter of
routine for such accounts.

3.6.11 The broad principles, outlined above, shall be applicable to all similar
relationships (custodial, trustee, etc).

3.6.12 Whenever there is a reconstitution, repositioning, merger, sale of business, etc. it
must be ensured by the Licensees concerned that liability is carried over clearly and
with all details passed on.

3.7 Opening and Conduct of Accounts of Government Entities

3.7.1 Licensees shall refer to the guidelines / requirements issued by the Ministry of
Finance with regards to the opening, conduct of operations and closing of
accounts of Government Entities.

3.8 Accounts Opened for Awqaf Purposes

3.8.1 Licensees must seek the required approvals from the Ministry of Awqaf and
Religious Affairs before opening any accounts in the names of mosques or any
other accounts related to Awqaf.

3.9 Accounts in the Names of Heirs of Deceased Pensioners

3.9.1 Licensees must, when opening accounts in the names of heirs of deceased
pensioners to be operated by nominated trustees, follow the procedures given
below :

3.9.1.1 Accounts shall be opened only when the original court order is received and
Licensees shall retain a copy verifying the original.

3.9.1.2 Accounts shall be opened in the names of the proper beneficiaries along with the
names of trustees.
3.9.1.3 Licensees shall also obtain and have on record properly authenticated certificates issued by the Pension Fund indicating the names of the beneficiaries.

3.9.1.4 Licensees shall verify the identity of the trustees and have on record copies of their identity cards / passports.16

3.10 **Accounts in the Names of Charitable Organizations and Collection of Money for Charitable Purposes**

3.10.1 Oman Charitable Organization is the officially recognized entity for charity money to be routed through.

3.10.2 Licensees should be associated with only officially recognized / accredited charitable bodies. They should refer to the concerned authorities in case any clarification is required.

3.10.3 In order for collection of money for overseas charity organizations, they must be backed by official recognition and documents and have prior approval of relevant Oman government authorities.17

3.10.4 Licensees should always be guided by various customer due diligence and KYC requirements and norms. The opening and conduct of such accounts in the nature of trust needs to be bestowed with more than ordinary care and control. As per Article 2 of the Executive Regulation of the Law of Money Laundering official certificate is necessary from the relevant ministry in the course of verification of identity of charitable societies and the like.

3.11 **Accounts in the Names of Diwan of Royal Court and its Offices**

3.11.1 Licensees must seek prior approval of the Minister of Diwan of Royal Court or his authorized representative for opening any accounts in the names of offices / units coming under the Diwan of Royal Court.

3.11.2 Licensees need to keep themselves updated with changes, if any, in the organizational structure of Diwan of Royal Court and the units attached to it.18

3.12 **Investment (Savings) Accounts**

3.12.1 Licensees can open investment (savings) accounts only in the names of individuals.

3.12.2 The only exception allowed in the above is the opening of such accounts in the names of charitable organisations.
3.12.3 Licensees shall observe needed due diligence requirements and ensure, among others, that such organizations for which investment (savings) accounts are opened have the license / approval of the government as the case may be.

3.12.4 While the prohibition against cheque book facility to investment (savings) accounts shall apply, the Licensees shall not bestow the benefits of promotion schemes intended for investment (savings) accounts of individuals on the above accounts.\textsuperscript{19}

### 3.13 Exchange of Currency / Bank Notes

3.13.1 Licensees shall obtain in detail the identities of all persons who seek to engage in exchange of currency / bank notes equal to or above RO 100/- and maintain registers containing details of identity and address of such customers. Licensees shall report immediately both to the Central Bank and Royal Oman Police whenever they detect counterfeit bank notes / money instruments.\textsuperscript{20}

### 3.14 Obtaining Identity Proof for Third Party Cash Deposits and Remittances

3.14.1 Licensees shall obtain the requisite identity documents from customers who deposit cash in others’ accounts and make remittances so as to comply with the Law of Combating Money Laundering and Terrorism Financing, its Executive Regulations and other instructions of the Central Bank.

3.14.2 In all relationships and transactions, Licensees shall ensure to comply with the required due diligence requirements under the Law of Combating Money Laundering and Terrorism Financing and other laws / rules / regulations / instructions.\textsuperscript{21}
4. Customers and Related Topics

4.1 Customer Complaints Redressal System

4.1.1 With a view to streamlining the requirements to address inadequacies of response to customer grievances and complaints and to have an organized and accountable system, the Central Bank has stipulated the following as minimum requirements:

4.1.1.1 Licensees must set up a separate department or section for redressal of complaints as well as communications and access including for the purpose of dialogue with the Central Bank directly.

4.1.1.2 Licensees must appoint a person, designated, in the Head Office of the domestic Licensee or main branch of the foreign Licensee for the purpose of acting as a focal point of reference for all complaints not being resolved by recipient offices and coordinator for the redressal system as a whole.

4.1.1.3 The focal functionary, not below the level of Assistant General Manager in a domestic Licensee / number 2 in main branch of the foreign Licensee, should be fully aware of the redressal system in the Licensee.

4.1.1.4 He should be communicative with concerned Licensee offices / departments, regulators and others, soliciting the assistance of legal and other professionals as may be necessary.

4.1.1.5 There should be back-up for the functionary to ensure continuity.

4.1.1.6 The names of focal persons in operating outlets and Head Office / main branch should be prominently displayed on the Notice Board and websites, in promotional material (brochures including electronic communications) or other means.

4.1.1.7 Licensees shall provide the names and contact details of Head of department / section (mentioned above) and the names of focal functionary (including subsequent changes, if any) to Central Bank without fail.

4.1.1.8 Licensees must educate their staff on the importance of dealing with customer grievances / complaints diligently. This is to be done systematically with the focus starting from new recruits and through periodical communications and interface with staff, including training programs.

4.1.1.9 Branch managers in smaller branches and departmental heads in bigger branches, in particular, should receive special attention to the sensitivity and be equal to deal
with issues and nuances involved. The culture of dealing with customer complaints with understanding, fairness and courtesy should be developed arduously.

4.1.1.10 Licensees must draw up policies and procedures to deal with grievances and complaints comprehensively. These should have to cover, at a minimum, the following:

4.1.1.10.1 Acknowledgement of the complaint (received through all modes or channels including electronic and through call centre) immediately;

4.1.1.10.2 Defining the process of dealing with speed and delegation;

4.1.1.10.3 Report to the focal functionary, mentioned above (even if complaint is resolved);

4.1.1.10.4 Special reference to focal functionary in case of assistance / escalation required;

4.1.1.10.5 Time-frame for resolution / final response (this may be reasonably graded in complex cases);

4.1.1.10.6 Final action taken by the Licensee with reasons in case of inadequate redressal (if there were to be genuine time-lag in resolution, customer must be advised and an adequate explanation should be given in case the complaint is not resolved to his satisfaction);

4.1.1.10.7 The roles of audit, compliance, legal and other support functionaries in contributing to the efficacy of the system;

4.1.1.10.8 Overall review process and scope for larger remedial / service-enhancement actions.

4.1.1.11 It is necessary for the top management and the Board to have periodical review of the redressal infrastructure and the efficiency of its functioning so as to make ongoing improvements.

4.1.1.12 The appointment of a designated person does not absolve the senior management and various operational units of their responsibility in maintaining efficiency and order and rendering assistance to the designated person in discharging his role.

4.1.1.13 Licensees must give importance to appropriate management information system, recording, evidencing and reviewing (at least quarterly) the number of complaints received category-wise (based on the nature), resolved and outstanding during a period. This should facilitate follow-up and critical analysis which should bring out organizational improvements.
4.1.1.14 The appropriate senior management committee shall review the redressal functioning at least quarterly, in detail, and the Board of Directors shall have half yearly review of the complaints of serious nature, if any, and the system in general, for the purpose of organisational excellence and policy re-visit.

4.1.1.15 Licensees shall provide a copy of the quarterly review to the Central Bank within 45 days from the end of the relevant quarter.

4.1.1.16 The Licensees’ audit and compliance units and the Central Bank’s examination shall have scrutiny within their mandate.22

4.2 Confidentiality in Banking Transactions

4.2.1.1 Licensees cannot disclose micro level credit information about their customers without the consent of the Central Bank. Further, if disclosure is to be permitted, the nature, quantum and modalities of disclosure will be determined by the Central Bank in accordance with the provisions of the Banking Law.

4.2.1.2 Licensees shall incorporate a condition in their financing agreements seeking prior consent of the customers allowing the Licensees to disclose such information as deemed necessary (e.g. names, status of financing obtained, etc.) for the purpose of pursuing legal or other actions in case of default.23

4.3 Customer Identification using National Identity Cards

4.3.1 The Central Bank recognizes the use of National Identity Cards as an official document for identification purposes and no Licensee should deny the acceptability of the same.24
5. Reporting Requirements

5.1 Structured Returns

5.1.1 The list of periodical and structured returns is given in Attachment 9.1. Licensees shall note to comply with the requirements, as applicable.

5.1.2 Licensees, having no figures to report, shall submit “NIL” reports.

5.1.3 Considering the relevance of prescribed submissions for regulatory, supervisory, compliance, statistical and policy requirements, Licensees shall ensure accuracy and timeliness and note that they shall attract penalties otherwise – as provided in the Banking Law/Regulation BM/REG/012/5/78/circular instructions.

5.1.4 Licensees shall have needed internal arrangements / back-up registers / audit trails for compilation and submission and review of examination and other requirements.

5.1.5 Licensees shall ensure that returns are submitted in a secured manner, defining responsibilities for submission through electronic or written medium, as the case may be, and marking distinctly the Departments in the Central Bank they are meant for.

5.1.6 Written submissions should be properly authenticated with authorized signatures, seals and dates.25

5.2 Other Reporting Requirements

5.2.1 Reporting to the Capital Market Authority (CMA):

5.2.1.1 Licensees are required to comply with the reporting requirements of CMA as laid down by it from time to time;

5.2.1.2 Licensees shall comply with all the reporting requirements stipulated by the CMA covering macro level institutional information without prior approval of the Central Bank but with an obligation to forward simultaneously to the Central Bank a copy of reports filed with the CMA.26

5.2.2 Proceedings of Annual General Meeting (AGM) and Extraordinary General Meeting (EGM):

5.2.2.1 Licensees should keep the Central Bank diligently and promptly informed of the proceedings of the AGM and EGM.27
6. Payment System

6.1 Cheque Imaging System

6.1.1 The Central Bank of Oman has prepared and introduced Cheque Imaging System ("CIS") Operating Rules for the benefit of the Licensees as Participant Banks. The CIS includes the daily cheque clearing process from the exchange of physical cheques amongst Clearing House Member Banks to a modern way of electronic clearing using cheque images and data.

6.1.2 All Licensees in the Sultanate which have been approved as CIS Participant Banks must strictly adopt the rules defined in the CIS Operating Rules document.

6.1.3 Changes in Physical Cheques Delivery to the Clearing House:

6.1.3.1 Licensees shall use the CIS equipment at their designated offices to capture the electronic cheque images and data of all physical cheques which they need to present to the Clearing House. Licensees must perform the outward clearing function using CIS and comply with the rules in the CIS Operating Rules document.

6.1.3.2 Presenting banks shall stop transporting the physical cheques from their offices to the Clearing House in Muscat for clearing and exchange with the collecting banks. Instead, presenting banks shall use the CIS system functions for the inquiry, reply or return of cheques (if necessary) based on cheque images.

6.1.3.3 In a situation where a presenting bank requests the collecting bank to perform a due diligent examination on the physical cheque, the presenting bank is required to mark the cheque as "special handling cheque" in the CIS. The presenting bank is then required to arrange, via its own means, for transportation of the physical cheque concerned to the premise of the collecting bank.

6.1.3.4 The Central Bank of Oman Clearing House in Muscat shall reject any physical cheques delivered by the Licensees for clearing with CIS operations now in place.

6.1.4 Changes in the Custody of Physical Cheques:

6.1.4.1 After the Licensees have completed the clearing process for cheques using CIS, the Bank of First Deposit ("BFD") shall preserve the physical cheques whose image they have presented. The BFD shall be required to keep custody / archive of the paper cheques within the BFD’s premises for a minimum period of 3 years from the date of payment of the cheques.
6.1.4.2 The Pay Bank may also have received physical cheques for those special handling cheques as indicated above. The Pay Bank shall likewise preserve the physical cheques in custody and archive them for a minimum period of 3 years.

6.1.4.3 For cheques which are rejected by CIS or returned by the Pay Bank due to any error, the BFD shall forward the rejected / returned cheques to the cheque payee customers. At the same time, the BFD must also print a “Rejected / Returned Cheque Advice” from the CIS for the rejected/returned cheque, which must show the reason for rejection / return.

6.1.4.4 The BFD and Pay Bank, as custodians of all physical cheques, are obliged to accept any request from the courts in Oman, or from the Central Bank, to retrieve any physical cheque when requested by a legal authority to provide the physical cheque as evidence in a court of law, or to hand over the cheque to the concerned customer under a proper procedure of acknowledgement and record for being produced in a court of law. The BFD and the Pay Bank must prepare their own internal procedures for administering such requests and shall comply with any necessary legal procedures.

6.2 Cheque Return System

6.2.1 The Central Bank requires the Licensees to implement the provisions of this system in order to monitor and disseminate information on cheques returned for non-availability or insufficiency of funds or for any other reason indicating intention of non-payment.

6.2.2 Licensees must provide the Central Bank with all information relating to returned cheques including account holders.

6.2.3 Information required also includes the name and identity details of the drawer, number, dates of issue and return, amount and payees of the returned cheques and the reasons for return, and any other data, as specified, for the purposes of analysis and policy formulation.

6.2.4 The Central Bank, based upon the Licensees’ submissions, will prepare a consolidated caution list of the referred account holders.

6.2.5 The Central Bank may also provide access to other licensed finance companies of the consolidated caution list for their exclusive credit-related uses.

6.2.6 The system of information sharing regarding returned cheques may be by electronic or any other mode set by the Central Bank. The Central Bank and all Licensees shall maintain utmost confidentiality, security and control in the
operation and use thereof, access being limited to specifically authorized persons suitable and responsible for the associated tasks. It shall be mandatory to ensure integrity of the system by such other means as timely, accurate and effective inputs and use.

6.2.7 Licensees must utilize the information exclusively for the purpose of implementation of this system.

6.2.8 Licensees must exercise caution in dealing with account holders whose names are listed in the Consolidated Caution List and shall withdraw cheque books from them and deny them checking accounts for a period of one year from the date of return of the last cheque, without prejudice to any monetary sanctions or other procedures specified by the Central Bank.

6.2.9 The sanctions specified in the Supervision and Control Title shall be applicable on Licensees on violation of the provisions of this Title.29

6.3 Cheque Books for Foreign Currency Accounts

6.3.1 Licensees can open deposit accounts for their customers in foreign currency provided that these encourage genuine savings and are backed up by trade and are not used for speculative activities or transactions.

6.3.2 In pursuance of Article 550 of the Oman Commercial Law seeking eventual settlement of certain foreign currency cheques in local currency, Licensees shall extend cheque book facility to be available in Rial Omani only, except in exceptional cases where, as an example, certain persons receive salaries in currencies other than Rial Omani.

6.3.3 Licensees are permitted to settle required foreign currency transactions by means other than cheque leaves.30
7. **Bancatakaful**

7.1.1 The following shall apply to the extent specified / modified by the Capital Market Authority.

7.1.2 Licensees may tie up with Takaful companies for marketing of their Takaful products pursuant to the directives issued by the CMA. The Licensees shall file a copy of the contract with the Central Bank.

7.1.3 The commission paid to the Licensee shall be a mutually agreed percentage of the Takaful premium collected by the Licensee in accordance with the contract between the parties. No additional commission shall be paid other than the above commission whether as administrative charge or reimbursement of expenses of profit commission. However, the Takaful company may share expenses of co-branded sales or publicity.

7.1.3.1 Licensees shall have an independent department at the corporate level to organize and administer bancatakaful functions which shall be headed by a manager with insurance qualifications (Association or Fellowship of a recognized insurance institute) and/or adequate experience of working in bancassurance / bancatakaful department of a bank or in an insurance / Takaful company in underwriting or marketing or in an insurance / Takaful brokerage firm. However, taking into consideration the size of the Licensee and its operations, the Central Bank may on merit exempt the Licensee from the above provision provided specified officer(s) and staff responsible for soliciting and dealing with Takaful business have been trained as per 7.1.3.2, 7.1.3.3 and 7.1.3.4 below.

7.1.3.2 Licensees desirous of carrying out bancatakaful business shall prepare training programs for their staff assigned to carry out such business. The training shall include as minimum basic principles of insurance and Takaful, Takaful products, methods of marketing, administrative procedures, the laws regulating Takaful business and Code of Practice for Conduct of Insurance Sector.

7.1.3.3 A Licensee may provide for deputation of experienced staff from the Takaful company to assist and guide the Licensee’s staff and customers and set out training mechanism as stated in the contract with the Takaful company.

7.1.3.4 Licensees shall commence marketing of Takaful products only after completion of training of the Licensee’s staff unless the Takaful company has provided its own staff as mentioned above.
7.1.3.5 The purchase of Takaful products by the customers of the Licensee shall be purely on voluntary basis and it should be clearly mentioned in the publicity material issued by the Licensee and the Takaful company.

7.1.3.6 For a customer who does not use Takaful services provided by the Licensee there should be no surcharge or any other cost. Nor should the Licensee allow any concession to a customer who uses Takaful services provided by the Licensee.

7.1.3.7 It should be clearly stated in the publicity material that the Takaful contract is between the Takaful company and the customer and not between the Licensee and the customer.

7.1.3.8 The Licensee must not charge any administrative fee or service charge or any other charge to the customer for Takaful services provided.

7.1.3.9 Unless the computer systems of the Licensee and the Takaful company are linked so that particulars of business transacted by the Licensee are automatically captured in the Takaful company’s system, the Licensee shall provide to the Takaful company a complete set of records in respect of the business sold on by the Licensee on daily, weekly or monthly basis as agreed with the Takaful company.

7.1.3.10 The Licensee shall submit to the Takaful company monthly statistics of business transacted through it in such form as may be prescribed by the Takaful company.

7.1.3.11 Sharing of information / data shall be to the extent agency business warrants and subject to customer confidentiality provisions being complied with.

7.1.3.12 Licensees shall adhere to all the applicable provisions / laws regulating the insurance / Takaful sector.

7.1.3.13 Licensees shall not impose their Takaful agency products / services on their clients compulsorily. The clients need to have the choice, and the purchase through the Licensees should be optional.

7.1.3.14 Licensees shall not provide incentives or disincentives on their Takaful agency through concessionary charge or administrative, service or any other charges / surcharges.

7.1.3.15 Licensees are prohibited to promote / advertise Takaful products from third parties as their own.

7.1.3.16 Licensees should develop a formula and mechanism to refund premiums on prepaid / foreclosed accounts and adjustments in topping up and spell them out
clearly. Whenever there is eligibility, refund / adjustment should be automatic without waiting for client’s request.

7.1.3.17 Licensees should file with the Central Bank a copy of the draft agreement with Takaful companies at least two weeks prior to proposed execution date along with relevant documentation. \(^{31}\)
8. **Other Instructions**

8.1 **Bank Charges**

8.1.1 With a view to providing a benchmark within which Licensees need to compete healthily the Central Bank stipulates the ceilings on bank charges for services / products as given in Attachment 9.2.

8.1.2 Licensees should not treat bank charges, insurance premium, etc. unduly as an extra source of compensation.

8.1.3 The ceilings prescribed for certain services / products should not be treated as entitlements and Licensees should decide on them with due consideration.

8.1.4 Licensees should obtain the Central Bank’s approval for new charges to be introduced besides noting to communicate the charges transparently and subject them to periodical review.

8.1.5 The Central Bank urges the Licensees not to take undue advantage of customers in the personal financing segment because of their committed salary linkages, adding to their financial burden unduly and non-transparently.

8.1.6 Licensees shall communicate their charges transparently and clearly through various modes including display on notice boards, pamphlets and electronic media, including websites. The coverage should be full and not partial.

8.1.7 The details of charges and rationale for the moderation shall be conveyed to all members of staff including counter staff so that tariffs are not applied across the board and discretion is exercised positively in appropriate cases, noting the public grievances on automatic application of table charges even for very nominal extra services.

8.1.8 Licensees shall introduce no-frill account with no extra charges to general public, who may neither need nor afford extra services, especially, the accounts of pensioners, recipients of social benefits and low salaries need to be treated sympathetically on charges, besides exempting specified account-holders from minimum balance charges as stipulated.

8.1.9 Whenever Licensees make changes on existing charges, they should be within the ceiling and arrangements / agreements with the customers should provide for the same. Besides, at least a month’s notice should be given.
8.1.10 It is the responsibility of the management, audit, compliance and other designated officials of the Licensees to ensure adherence to stipulations with reason and understanding.

8.1.11 Complaints Redressal System and Quality Assurance should provide review comforts.

8.1.12 Licensees should have a system to build and report data on earnings from different tariffs as a matter of management information and periodical requirements of reporting to the Board.

8.1.13 The Central Bank may also call for the same in future and seek public disclosure.

8.1.14 Licensees should make an appropriately larger review whenever a complaint is received on excess and should make refund on all erroneous cases. Whenever there are excesses pointed out by the customer or anybody else, refund should be made at the earliest (not later than a week).  

8.2 Promotions

8.2.1 Promotional Stalls

8.2.1.1 The Central Bank allows the Licensees to set up promotional stalls themselves without the need to obtain approval from the Central Bank.

8.2.1.2 Licensees should evolve appropriate internal policy for setting up stalls and it must be duly approved by the Board / Controlling Offices.

8.2.1.3 The policy should cover all relevant aspects like commercial and other considerations of justification and discretion for approvals at the operational level (this should be done at senior management level and there should be an appropriate system of review).

8.2.1.4 The policy should be backed up by systems and procedures to ensure diligence in operationalizing. Coverage should specify requisites like appropriate market survey, staff, IT and other infrastructure required for efficiency, safety, monitoring, audit, control, compliance, risk management and reporting.

8.2.1.5 The scope of stalls should not be intended to be transaction-oriented. The stalls should be marketing tools along accepted lines and not operational outlets. Stalls should be capably staffed and managed (preferably attached to Head Office or main/big branch). The focus should preferably be to build up a wide base of customers, business and image.
8.2.1.6 Staff must be appropriately trained and follow code of ethics reflective of integrity and reputation of the financial sector. They should display their identity prominently.

8.2.1.7 Licensees must observe utmost clarity, truthfulness, transparency and fairness in their communications in the stalls.

8.2.1.8 Stalls must have pre-announced days of openings and timings and if there is abrupt discontinuity it should be disclosed reasonably ahead of time. Licensees should not over-stretch.

8.2.1.9 Licensees must obey Labour law provisions and other applicable rules and regulations at all times.

8.2.1.10 Promotional stalls shall also be subjected to normal control, audit and compliance requirements.  

8.2.2 **Promotion of Banking Products and Services**

8.2.2.1 Licensees are permitted to do publicity for any outward remittances as part of their banking business, subject to the following conditions:

8.2.2.1.1 The above authorization is related to normal commercial banking business only, and non-routine correspondent relationships, dedicated arrangements and investment banking products and services shall undergo specific approval / compliance requirements.

8.2.2.1.2 Licensees are required to be diligent in entering correspondent and other arrangements and to observe utmost transparency and fair practices while dealing with the public.

8.2.2.1.3 The publicity shall primarily focus on the Licensees’ own business rather than overseas entity and products and services (but for incidental references).

8.2.2.1.4 Licensees are not permitted to take up undue liability / responsibility in the process though the public would expect normal diligence required of them.
8.3 **Retention of Bank Records and Documents**

8.3.1 Licensees shall refer to Title on Operational Risk for details on retention period of bank records and documents. It may be noted that under the Law of Combating Money Laundering and Terrorism Financing and its Executive Regulations, the minimum retention period prescribed is ten years.

8.4 **Execution of Decisions Given by the Authority for the Settlement of Commercial Disputes**

8.4.1 The Authority for Settling of Commercial Disputes (ASCD) has clarified to the Central Bank that ASCD’s decisions relating to seizure of defendants’ funds and other chattels depends on the nature of conflict. In addition, while executing decisions, legally established rights of the Licensees to funds and properties of the defendants are not jeopardized.\(^{35}\)

8.4.2 The Authority mentioned above may approach any Licensee, upon the request of a judgment creditor for the attachment of any account related to a customer (debtor) against whom a decision has been issued by the Authority. The Licensee should immediately implement the attachment instructions without recourse to the Central Bank, and inform the Authority about the steps taken regarding the attachment.

8.5 **Registration of Trade Names**

8.5.1 Licensees should register specific names / brands / trademarks of their products with the Ministry of Commerce and Industry.\(^{36}\)

8.6 **Contribution to Charitable Causes**

8.6.1 Licensees are strongly encouraged to waive bank charges on donations made for charitable causes particularly in relation to Zakat and similar noteworthy contributions.

8.6.2 Licensees are also encouraged not to apply commercial considerations to remittances and related businesses in connection with accredited / recognized charitable causes and bodies.\(^{37}\)
8.7 Guarantees

8.7.1 Invocation of Guarantee

Licensees shall take note of the Royal Decree mandating the Licensees to dispossess the debtor before resorting to Guarantors.\textsuperscript{38}

8.7.2 Guarantee format

8.7.2.1 The formats of the Guarantees and performance bonds shall include therein the extract of Article 396 of Oman Law of Commerce No. 55/1990 as a footnote which is required to be discerned clearly.

8.7.2.2 "A bank shall be released in relation to the beneficiary if a demand from the beneficiary for payment does not reach it within the validity period of the letter of guarantee, unless it is expressly agreed prior to the coming to an end of such period that the same is to be renewed".

8.7.2.3 Consequent upon the introduction of the revised format of the bond / guarantee as stipulated above, Licensees will take steps to cancel the relative bonds / guarantees in their books soon after the expiry thereof under advice to the beneficiaries concerned. However, it would be in the interest of the Licensees to follow up the return of such bonds / guarantees for cancellation and updating of records.\textsuperscript{39}
8.8 Banking Day / Hours

8.8.1 Licensees shall adhere to the working days / hours specified by the Central Bank from time to time.

8.9 Construction of Own Head Office Buildings

8.9.1 Licensees wanting to construct their own Head Office building may do so in conformity with the government / municipality regulations in their area.

8.9.2 Licensees may also lease out, without any restriction, any office space at their Head Office premises. However, Licensees are not permitted to lease out accommodation flats in such buildings (though they may use such accommodation flats to accommodate their own staff).  

8.10 Reference to Central Bank

8.10.1 Licensees shall not attribute their inability to accede to the requests of their customers for various facilities to the rules and regulations issued by the Central Bank.
9. Attachments

9.1 List of Returns to be Submitted to the Central Bank

<table>
<thead>
<tr>
<th>CBO Department</th>
<th>Return</th>
<th>Periodicity</th>
<th>Last Date for Receipt</th>
<th>Reference of Circulars/Circular Letters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Research &amp; Statistics Dept (ERSD)</td>
<td>RD8 – Profit rates on Domestic inter-bank financing in Rial Omani</td>
<td>Daily</td>
<td>End of the day</td>
<td>CBO/ERSD/0 4/ 335 dated 24.7.2004</td>
</tr>
<tr>
<td>1</td>
<td>Form RD1 - Assets *</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO/ERSD/2 005 BM 736</td>
</tr>
<tr>
<td>2</td>
<td>Form RD2 – Liabilities *</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO/ERSD/2 005 BM 736</td>
</tr>
<tr>
<td>3</td>
<td>Form RD3 – Contra accounts and other information *</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO/ERSD/2 005 BM 736</td>
</tr>
<tr>
<td>4</td>
<td>Form RD4- Assets in Rial Omani and Foreign Currency *</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO/ERSD/2 005 BM 736</td>
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<tr>
<td>5</td>
<td>Form RD5 – Liabilities in Rial Omani and Foreign Currency *</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO/ERSD/2 005 BM 736</td>
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<td>6</td>
<td>Form RD 9 – Monthly statement of Profit Rates on Deposits</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO Rd 97 942 BM 743</td>
</tr>
<tr>
<td>7</td>
<td>Form RD10 – Monthly statement of Private Sector Time deposits by rate of profit and maturity</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO Rd 97 942 BM 743</td>
</tr>
<tr>
<td>8</td>
<td>Form RD11- Monthly statement of Profit rates on Bills, Financing, Advances and Overdrafts</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO Rd 97 942</td>
</tr>
<tr>
<td>9</td>
<td>Form RD12- Monthly statement of Private Sector Credit by rate of profit and maturity</td>
<td>Monthly</td>
<td>15 days following every month end</td>
<td>CBO Rd 97 942</td>
</tr>
<tr>
<td>10</td>
<td>Form 7A – Deposits held with commercial banks by Government, wholly owned Government entities and quasi-Government entities</td>
<td>Quarterly</td>
<td>30 days after the end of each quarter</td>
<td>CBO/RD/200 1/ 227</td>
</tr>
<tr>
<td>11</td>
<td>Form 7B- Credit granted to Government and Government entities/quasi Government entities</td>
<td>Quarterly</td>
<td>30 days after the end of each quarter</td>
<td>CBO/RD/200 1/ 227</td>
</tr>
<tr>
<td>12</td>
<td>Form 7C-Deposits of specialized banks with commercial banks</td>
<td>Quarterly</td>
<td>30 days after the end of each quarter</td>
<td>CBO/RD/200 1/ 227</td>
</tr>
<tr>
<td>13</td>
<td>Form RD15- Quarterly statement on financing by economic sectors</td>
<td>Quarterly</td>
<td>Within a month from the end of the quarter</td>
<td>CBO/RD/99/0 68 dated 21.2.99</td>
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* Copy each of RD 1, RD 2, RD 3, RD 4 and RD 5 shall be submitted to Banking Development Department
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<table>
<thead>
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<tbody>
<tr>
<td><strong>15</strong></td>
<td>Form BOP1 – Quarterly supplementary return on outward private remittances by expatriates</td>
<td>Quarterly</td>
</tr>
<tr>
<td><strong>16</strong></td>
<td>Form BOP 2- Quarterly supplementary return on outward private remittances by expatriates</td>
<td>Quarterly</td>
</tr>
<tr>
<td><strong>17</strong></td>
<td>Annual statement of earnings and expenses of commercial banks</td>
<td>Annual</td>
</tr>
</tbody>
</table>

**II** Treasury, Investment & Monetary Operations Dept (TIMOD)

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>Monetary Operations Domain</td>
<td>Information on Reserve Requirement</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>TIMOD</td>
<td>Foreign Exchange Maturity Profile</td>
</tr>
</tbody>
</table>

**III** Payment Systems Dept

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>Payment System Statistics Table 6</td>
<td>Quarterly</td>
</tr>
<tr>
<td><strong>2</strong></td>
<td>Payment System Statistics Table 7</td>
<td>Quarterly</td>
</tr>
<tr>
<td><strong>3</strong></td>
<td>Payment System Statistics Table 8 and 9 (combined)</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>

**IV** Banking Surveillance Dept -

**A) BOSS Unit**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong></td>
<td>BIS Capital Adequacy Report</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>
### Islamic Banking Regulatory Framework

<table>
<thead>
<tr>
<th></th>
<th>Data to support Standardized Approach</th>
<th>Data to support AMA</th>
<th>Other Data</th>
<th>Monthly</th>
<th>Within 10 days of the end of the month</th>
<th>BM 955</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Risk Management Returns (Commercial Banks)</td>
<td>Report on Maturities of assets and liabilities (MAL)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Report on Sensitivities of assets and liabilities (SAL)</td>
<td>Report on Forex Position</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>FLC Off-site Returns</td>
<td></td>
<td></td>
<td>Quarterly*</td>
<td>Within one month of the end of the quarter</td>
<td>FM 21</td>
</tr>
<tr>
<td></td>
<td>Income Statement</td>
<td>Balance Sheet</td>
<td>Schedules (26 schedules)</td>
<td>Maturity Profile of Assets and Liabilities</td>
<td>Re-pricing of Assets and Liabilities</td>
<td>Effective Annual Profit Yield / Cost</td>
</tr>
<tr>
<td></td>
<td>*(Additionally, The Income Statement and Balance Sheet without schedules are required to be sent by FLCs on a monthly basis)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>BOSS Return (Specialized Banks) - Introduced from December 2006</td>
<td>Quarterly</td>
<td>Within one month of the end of the quarter</td>
<td></td>
<td>BSD/2006/BKUP/AHB/1157, BSD/2006/BKUP/ODB/1158 and BSD/2006/BKUP/OHB/1159 dated November 2006 for AHB, ODB and OHB, respectively.</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Risk Management Returns (Specialized banks) - Introduced from December 2006</td>
<td>Monthly</td>
<td>Within one month of the end of the month</td>
<td>Same as above</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Annual Financial Approval - set of documents - Banks</td>
<td>Annual</td>
<td>Before 31st January of the succeeding year</td>
<td>BM 980</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Report on Country &amp; Transfer Risks (Reporting introduced from December 2006)</td>
<td>Quarterly</td>
<td>Within one month of the end of Quarter</td>
<td>BM 1014</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### B) Overseas Banking Monitoring Unit (OBMU)

<table>
<thead>
<tr>
<th></th>
<th>Activity</th>
<th>Frequency</th>
<th>Deadline</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Placements of bank funds abroad</td>
<td>Monthly</td>
<td>Within 10 days of the end of the month</td>
<td>BM 997</td>
</tr>
<tr>
<td>2</td>
<td>Financing to non-residents in foreign currencies for operations abroad</td>
<td>Quarterly</td>
<td>Within 15 days of the end of the quarter</td>
<td>BM 997</td>
</tr>
<tr>
<td>3</td>
<td>Syndicated financing in foreign currency</td>
<td>Quarterly</td>
<td>Within 15 days of the end of the quarter</td>
<td>BM 997</td>
</tr>
<tr>
<td>4</td>
<td>Indemnity Agreements / Guarantees / Warranties issued by licensed banks</td>
<td>Quarterly</td>
<td>Within 15 days of the end of the quarter</td>
<td>BM 827</td>
</tr>
<tr>
<td></td>
<td>within &amp; outside the Sultanate of Oman</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Overseas Branches Reporting (OBR 1 to OBR 11)</td>
<td>Monthly and Quarterly</td>
<td>Within 15 days of the date of the report.</td>
<td>BSD 2002 BKUP BW 140 dated 26/02/02</td>
</tr>
<tr>
<td></td>
<td>OBR 1 - Statement of Assets</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-2 - Statement of Liabilities</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-3 - Off Balance Sheet Items</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-4 - Credit &amp; Investment Portfolio</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-5 - Profit &amp; Loss Account</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-6 - Deposits</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-7 - Concentration of Credit</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-8 - Asset Quality</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-9 - Maturities of Assets and Liabilities - Country-wise</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-10 - Foreign Exchange Position - Country-wise</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>OBR-11 - Other Information BIS Capital Ratio</td>
<td>Quarterly</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### C) BCSB Unit

<table>
<thead>
<tr>
<th></th>
<th>Activity</th>
<th>Frequency</th>
<th>Deadline</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Reporting of all financial facilities</td>
<td>Monthly</td>
<td>Within 15 days of the end of the month</td>
<td>BM 689 dated May 1, 1993</td>
</tr>
<tr>
<td>2</td>
<td>Certificate of compliance with BM 985 instructions on lendings to senior members</td>
<td>Quarterly</td>
<td>Within 15 days of the quarter; In case of December quarter, auditor certified compliance required by 31st of December.</td>
<td>BM 985</td>
</tr>
<tr>
<td>3</td>
<td>List of persons to whom credit facilities have been extended in excess of the limitation on lending</td>
<td>Quarterly</td>
<td>Within 15 days of the quarter</td>
<td>BEd/Gen/91/707 dated 28 January 1992</td>
</tr>
<tr>
<td>4</td>
<td>Customer-wise classification of advances - Technical Write-offs</td>
<td>Monthly</td>
<td>On or before the 15th of succeeding month</td>
<td>BSD/2006/BC SB/Banks/FL Cs/266 dated 13/03/2006 (Reference BM 912)</td>
</tr>
<tr>
<td>5</td>
<td>Customer-wise classification of off-balance sheet exposures</td>
<td>Monthly</td>
<td>On or before the 15th of succeeding month</td>
<td>BSD/2006/BC SB/Banks/393 dated April 2, 2006</td>
</tr>
<tr>
<td>7</td>
<td>Database on Senior Members &amp; Related Parties - Domestic Banks</td>
<td>Annually</td>
<td>By January 15th of the succeeding year for position as on 31st December of previous year</td>
<td>BSD/2002/BKUP/Banks/647 dated 9/3/2002</td>
</tr>
<tr>
<td>8</td>
<td>Database on Country Heads &amp; Related Parties - Foreign banks</td>
<td>Annually</td>
<td>By January 15th of the succeeding year for position as on 31st December of previous year</td>
<td>BSD/2005/BC SB/FBanks/07 dated 3/1/2005</td>
</tr>
<tr>
<td>9</td>
<td>Database on Senior Members &amp; Related Parties - Specialized Banks</td>
<td>Annually</td>
<td>By January 15th of the succeeding year for position as on 31st December of previous year</td>
<td>BSD/2005/BC SB/Sbanks/20 dated 5/1/2005</td>
</tr>
</tbody>
</table>

Note: Banks which are listed in the MSM and submit their quarterly financials to CMA, should forward a copy thereof to BSD.

V Banking Examination Dept

<p>| 1 | Obtention of Audited Financials from bank credit users of the Sultanate’s Banking System | Quarterly | 15th of the month following the quarter | BED/2002/BKUP-526/BANKS/667 BED/2005/BKUP-194/BANKS/267 |
| 2 | Exposure backed by stock market securities and related aspects | Half yearly | 15th of the month following the half year | BSD/99/BKUP-464/Banks/643 |</p>
<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Frequency</th>
<th>Date of Compliance</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Compliance Certificate</td>
<td>Half yearly</td>
<td>20th of the month following the half year</td>
<td>BSD/2006/BKUP-268/BANKS/364</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VI</td>
<td>Banking Development Dept</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Lending Ratio</td>
<td>Monthly</td>
<td>15th day of the following month</td>
<td>BM 849, 850 and 887</td>
</tr>
<tr>
<td>2</td>
<td>Reserve Requirement</td>
<td>Monthly</td>
<td>5th working day after the end of the computation period</td>
<td>BM 1005 and 1022</td>
</tr>
<tr>
<td>3</td>
<td>Omanisation</td>
<td>Quarterly</td>
<td></td>
<td>BM 762</td>
</tr>
<tr>
<td>4</td>
<td>Personal Financing</td>
<td>Monthly</td>
<td>15 days following every month-end (through Return RD 3)</td>
<td>BM 983, 1001</td>
</tr>
<tr>
<td>5</td>
<td>Financing by banks for purchase of shares and share market operations</td>
<td>Quarterly</td>
<td>15 days following month-end</td>
<td>Circular letter BA/DD/CB/97/373 dated 29.4.1997</td>
</tr>
<tr>
<td>6</td>
<td>Investments</td>
<td>Monthly</td>
<td>15 days following the month-end</td>
<td>BM 958</td>
</tr>
<tr>
<td>7</td>
<td>Profit on Credit Cards</td>
<td>Quarterly</td>
<td>15 days following quarter-end</td>
<td>BM 983</td>
</tr>
<tr>
<td>8</td>
<td>Branch Performance Report</td>
<td>Half Yearly</td>
<td>30 days from the end of half year</td>
<td>BM 417</td>
</tr>
<tr>
<td>9</td>
<td>Suspicious Transactions</td>
<td>Quarterly</td>
<td>15 days following quarter-end</td>
<td>BM 880</td>
</tr>
</tbody>
</table>

** made quarterly now, as against earlier monthly requirement
### 9.2 Central Bank Mandated Ceilings on Bank Charges for Certain Products / Services

<table>
<thead>
<tr>
<th>Types of Charges</th>
<th>Maximum Charges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Balance Charges in respect of Savings Accounts</td>
<td>Bz. 500 per month</td>
</tr>
<tr>
<td>(Minimum balance prescribed not to exceed RO 100)</td>
<td></td>
</tr>
<tr>
<td>Minimum Balance Charges in respect of Current Accounts</td>
<td>Bz. 500 per month</td>
</tr>
<tr>
<td>(Minimum balance prescribed not to exceed RO 200)</td>
<td></td>
</tr>
<tr>
<td><strong>No charges shall be levied under this head if the account is maintained for the purpose of receiving Pension and other Social Support Allowance being granted by the Government to pensioners and disabled persons. No charges shall be levied resulting in balance becoming debit.</strong></td>
<td></td>
</tr>
<tr>
<td>Issue of any Certificate by the Licensee to its customers such as Balance Confirmation, Nil Liability or No Due Certificate etc.</td>
<td>RO 2 per certificate</td>
</tr>
<tr>
<td>Cheque Return Charges</td>
<td>RO 15 (minimum RO 10)</td>
</tr>
<tr>
<td>There shall be no penalty for cheque return on account-holder presenting the cheque for collection (Refer Circular BM 730 dated 4 July 1994)</td>
<td></td>
</tr>
<tr>
<td>Stop Payment of Cheques (either single cheque or bunch of serially numbered cheques)</td>
<td>RO 5</td>
</tr>
<tr>
<td>This ceiling applies also to cancellation of Stop Payment instructions</td>
<td></td>
</tr>
<tr>
<td>Photocopy of paid cheque</td>
<td>RO 2 if the cheque is within one year period and RO 3 if the cheque is more than one year old</td>
</tr>
<tr>
<td>Dormant Accounts</td>
<td>Nil charges, if the account has the prescribed minimum balance</td>
</tr>
<tr>
<td></td>
<td>RO 1 per half year or RO 2 per year if the account does not have the minimum balance.</td>
</tr>
<tr>
<td>Closure of Accounts</td>
<td>No charges are to be levied if the account is more than one year old</td>
</tr>
<tr>
<td></td>
<td>RO 3 if the account is closed within one year.</td>
</tr>
<tr>
<td>Collection of Outstation Cheques</td>
<td>Bz. 500 to be shared equally by the collecting bank and the paying bank.</td>
</tr>
<tr>
<td>Service</td>
<td>Fee</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>----------------------</td>
</tr>
</tbody>
</table>
| Cheque Leaves                       | RO 1 per book of 10 leaves  
RO 2 per book of 25 leaves  
RO 3 per book of 50 leaves  
RO 5 per book of 100 leaves        |
| ATM Cards                           |                      |
| New Cards                           | RO 1                 |
| Supplementary Cards                 | RO 2                 |
| Replacements                        | RO 2                 |
| Annual fee for Debit Cards          | RO 1                 |
| (Refer to BM 996 dated 20 Feb. 2006)|                      |
| Cash Withdrawal through ATM of the  | Bz. 100              |
| other network within Oman Switch    |                      |
| Bank Statements (other than normal | RO 5 p.a. for monthly  
periodicity as agreed)             | statements              |
|                                    | RO 20 p.a. for weekly |
|                                    | statements            |
|                                    | RO 50 p.a. for daily  
statements            |
| Duplicate Statements               | RO 1 up to 6-month   
old statements          |
|                                    | RO 3 for 6-12 months |
|                                    | RO 5 beyond one year  |
| Utility Payments                    | Bz. 500 for own      
customers and RO 1 for   |
|                                    | others               |
| DD/Pay Orders                       | RO 2                 |
| Standing Instructions               | RO 1 for intra-bank  
transactions          |
|                                    | RO 2 for others       |
| Caution List Removal processing*    | RO 10 for individuals |
|                                    | RO 20 for others      |
| Premature Closure of deposits       | No deduction from     
Principal. Profit      |
|                                    | Payment may be       |
|                                    | reduced by 1% p.a.   |
|                                    | for the period run   |
|                                    | subject to SSB       |
|                                    | approval             |
| Remittances                         | RO 1 for local       |
|                                    | remittances and RO 5 |
|                                    | for overseas         |
|                                    | remittances (actual   |
|                                    | out of pocket        |
|                                    | expenses/other bank  |
|                                    | charges extra        |

*These requests are to be taken up with Central Bank, on exceptional basis, on merit.*
<table>
<thead>
<tr>
<th>Inward credits to Accounts</th>
<th>RO 1 for local remittances and RO 5 for overseas remittances (actual out of pocket expenses / other bank charges extra)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Personal financing</strong></td>
<td><strong>RO 5</strong></td>
</tr>
<tr>
<td>Installment Waiver charges that could be levied only if the installment is waived at the request of the customer.</td>
<td>(No charges shall be levied if the Licensee is offering this as a gesture on various occasions such as Eid, National Day, etc.)</td>
</tr>
<tr>
<td><em>These charges will be subject to approval from SSB and taken to charity fund as per SSB guidance</em></td>
<td></td>
</tr>
</tbody>
</table>

2 BM 816  
3 FSB papers and BIS papers  
4 BM 762  
5 Regulation BM/REG/10/11/75  
7 BM 697  
8 Article 67 of the Banking Law  
10 Circular letter no. BDD/CBS/CB/2010/8499 dated 21 Nov. 2010  
11 BM 798  
12 Article 71 of the Banking Law  
13 BM 1045  
14 Circular letter no. BDD/185 dated 11 Jan 2005  
18 Circular letter no. BDD/CBS/CB/2010/5731 dated 21 July 2010  
21 Circular letter no. BDD/4841 dated 28 July 2009  
22 BM 1043  
23 BM 943  
24 BM 485  
25 BM 1023  
26 BM 913  
28 BM 1056  
29 BM 1030  
31 BM 1070
32 BM 1068
33 BM 1025
34 BM 1015
35 BM 608
38 Circular letter no. BDD/5248 dated 6 July 2010
39 BM 956
40 BM 747
41 BM 415