

GUIDELINES ON SINGLE COUNTERPARTY EXPOSURE LIMIT FOR LABUAN BANKS

1.0 Introduction

- 1.1 Risk concentration refers to an exposure with the potential to produce losses that are substantial enough to threaten the financial condition of a Labuan bank. Risk concentrations can materialise from excessive exposures to a single counterparty or group of connected counterparties, a particular instrument or a particular market segment. A risk concentration to a single counterparty may arise through direct exposures to the counterparty and indirectly through exposures to protection providers, such as guarantors and credit derivatives counterparties. The magnitude of this risk is significantly influenced by the existence of common or correlated risk factors which in times of stress can adversely affect the creditworthiness of each individual counterparty making up the concentration.
- 1.2 The single counterparty exposure limit (SCEL) is a non-risk adjusted back-stop measure to ensure that exposures to a single counterparty or a group of connected counterparties are within a prudent limit at all times.
- 1.3 The Guidelines sets out:
- (a) Labuan Financial Services Authority's (Labuan FSA) expectations of Labuan banks in managing and monitoring exposures to a single counterparty;
 - (b) the prudential limit for exposures to a single counterparty;
 - (c) parameters for identifying connected counterparties that constitute a single counterparty;
 - (d) scope and treatment of exposures applicable to a single counterparty; and
 - (e) expectations with respect to on-going compliance with the SCEL.

2.0 Applicability

- 2.1 The Guidelines is applicable to all Labuan banks under the following categories:
- (a) Labuan bank licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);

- (b) Labuan Islamic bank licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and
- (c) Labuan bank that has been given approval to undertake its business as a Labuan Islamic bank under Part VI of LIFSSA.

The requirements of this Guidelines are not applicable to Labuan banks operating as branches. Notwithstanding this, it is expected that they shall comply with the risk concentrations and/or large exposures' requirements imposed by their home regulatory authorities. In this regard, the Labuan banks operating as branches are required to provide a written confirmation from their head offices that their head offices are subject to the regulatory requirements on large exposures in their home jurisdictions which are applicable on a global basis including the branch in Labuan.

3.0 Legal Provisions

- 3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) in respect of Labuan banking business¹ or Labuan Islamic banking business¹ for the purpose of clarifying prudential requirements in relation to SCEL.
- 3.2 Any person who fails to comply with the Guidelines commits an offence and may be punishable under Section 36B and 36G of the LFSAA.

4.0 Effective Date

- 4.1 The Guidelines shall come into effect on 1 January 2014 and would remain effective and applicable unless amended or revoked.
- 4.2 The Guidelines supersedes the **Guidelines on Concentration of Credit** issued on 8 April 1997.

5.0 Definition and Interpretation

- 5.1 For the purpose of this Guidelines:

Exposure refers to all claims, commitments and contingent liabilities arising from on- and off-balance sheet transactions (in both the banking and trading books) in foreign currency and ringgit² denomination, which include, but is not limited to:

¹ Excluding Labuan financial business and Labuan Islamic financial business.

² Where permitted by the Financial Services Act 2013, Islamic Financial Services Act 2013 or such other relevant law in force.

- (a) outstanding loans/financing, advances and receivables. These amounts comprise outstanding balance (i.e. principal amount and accrued interest/profit rate) as at reporting date, which has not yet been repaid;
- (b) deposit placements and margins held with counterparties;
- (c) debt and equity securities held, including exposures arising from holdings of primary market securities for distribution;
- (d) investments in collective investment schemes;
- (e) exposures arising from derivative contracts; and
- (f) exposures under off-balance sheet instruments.

Large exposure refers to total exposures to a single counterparty which is equal to or greater than 10% of the Labuan bank's total capital.

Interbank money market transactions refers to foreign currency transactions in the money market with a contractual maturity of one year and below which include secured or unsecured borrowing and lending, and buying and selling of papers with a remaining maturity of one year and below.

Total capital has the same meaning assigned to it in the *Guidelines on Risk-Weighted Capital Adequacy* issued by Labuan FSA. For Labuan-incorporated banks, the total capital for the purpose of determining the exposure limit to a single counterparty or a group of connected counterparties under this Guidelines shall be its own capital base.

6.0 Risk Management Expectations

- 6.1 The board of directors (Board) must ensure that:
- (a) the Labuan bank establishes and adheres at all times to the internal policies governing risk concentrations, as approved by the Board;
 - (b) the internal policies are reviewed regularly (at least annually) in order to remain current, adequate and appropriate for the Labuan bank at all times. Any material changes to the established policies must be approved by the Board; and
 - (c) independent³ reviews are conducted regularly to verify compliance to the prudential limit and standards set by Labuan FSA as well as the established internal policies.
- 6.2 Senior management must:
- (a) establish and implement internal policies, processes and procedures governing risk concentrations;

³ Independent of risk taking activities.

- (b) clearly communicate and monitor compliance with the internal policies; and
 - (c) establish and maintain adequate systems (either automated or otherwise) that are able to identify, measure, monitor and aggregate exposures to single counterparties in a timely manner.
- 6.3 The internal policies on risk concentration must at a minimum include the following:
- (a) procedures for identifying, measuring, monitoring⁴, controlling and reporting single counterparty exposures of the Labuan bank;
 - (b) detailed internal parameters for identifying connected counterparties;
 - (c) internal exposure limits (including limits on large exposures⁵) that are reflective of the Labuan bank's risk appetite and risk bearing capacity, and also take into consideration the potential changes to the market value of the underlying exposures;
 - (d) clearly defined roles and accountability for ensuring compliance and effective communication of the policies, procedures and internal limits to business lines;
 - (e) measures to manage and address compliance with the SCEL, including authority and processes for approving exceptions to the internal limits which in any case, must not exceed the SCEL; and
 - (f) nature and frequency of reporting to the Board and senior management.
- 6.4 Although certain types of exposures and counterparties are excluded from the SCEL (as specified in paragraph 9.1), these exposures are not risk-free. Labuan banks should have adequate procedures and controls in place to monitor these exposures. In addition, Labuan banks should also ensure that their portfolios are not overly concentrated in large exposures.

7.0 Single Counterparty Exposure Limit

- 7.1 Labuan banks shall comply with the SCEL at all times whereby total exposure to a single counterparty must not exceed 25% of the Labuan bank's total capital.
- 7.2 A Labuan bank that has an exposure arising from loss-bearing fund placements made with an Islamic bank/Islamic banking operation must apply the look-through approach as described in **Appendix I**. An Islamic bank/Islamic banking operation who is the fund manager in this arrangement will not be subjected to the SCEL.

⁴ Exposures are expected to be monitored on a gross basis, regardless of mitigation allowed.

⁵ A large exposure is defined in paragraph 5.1.

- 7.3 For the purpose of compliance with the SCEL, an exposure that is guaranteed or protected by credit derivatives must be aggregated to the direct counterparty and the same exposure is also separately aggregated to the guarantor or protection provider. In circumstances where the counterparty and its guarantor or protection provider are connected (hence, treated as a single counterparty), the exposure should be aggregated as a single group exposure to the direct counterparty and the guarantor or protection provider.
- 7.4 Notwithstanding the requirement in paragraph 7.1, a Labuan bank may apply to Labuan FSA to be considered to use its parent's⁶ capital for the purpose of SCEL computation. The application should include information on parental support conferred to the Labuan bank, in addition to the parental guarantee⁷, that can mitigate the risk exposures from the single counterparty transactions. The application should detail on the adequacy and enforceability of the support by the parent for the Labuan bank's exposures. In considering the application, among others, Labuan FSA will take into account whether the applicant bank has good governance and effective risk management practices.

8.0 Definition of a Single Counterparty

- 8.1 Counterparties are regarded as connected where two or more counterparties are interlinked and present a common risk to the Labuan bank, such that difficulties faced by any of the counterparties may affect the funding or repayment capabilities of one or all of the counterparties.
- 8.2 Counterparties must be aggregated if:
- (a) one of the counterparties holds directly or indirectly, power of control over the other(s) through shareholding, shared management or directorship based on criteria specified in **Appendix II**; or
 - (b) two or more of the counterparties are connected due to economic dependence and the exposures are:
 - (i) material between the counterparties [for scenarios (a) to (e) in **Appendix III**]; and
 - (ii) the relationship between the counterparties is not easily substituted in the short term [for scenario (e) in **Appendix III**];to the extent that failure or financial difficulties experienced by one counterparty will significantly affect and impair the ability of another counterparty to honour its financial obligations.

⁶ Parent denotes the major or ultimate shareholder of the Labuan bank.

⁷ Parental guarantee that was provided to Labuan FSA during licensing.

- 8.3 Labuan banks must have in place procedures for conducting economic dependence assessments, which shall at least cover its large exposures as defined in this Guidelines.
- 8.4 Labuan banks should also endeavour to conduct economic dependence assessment for all other exposures considered material to the bank based on the bank's risk tolerance, to determine the extent of exposure to a single counterparty.
- 8.5 Where exposures are aggregated through power of control, Labuan bank may disaggregate the exposures if the following criteria are met:
- (a) the entity has sufficient financial resources of its own to obtain credit facilities and to fully service its liabilities; and
 - (b) the entity is not relied upon to support the liabilities of any other counterparty in its single counterparty group out of its financial resources.
- 8.6 Exposures to entities that are disaggregated according to paragraph 8.5 may be treated as a separate single counterparty. Labuan banks must document the assessments to support such disaggregation. The documentation must be accessible to the internal control and risk management functions at all times.
- 8.7 Labuan banks must exercise a reasonable degree of due diligence, including applying the principle of "know your customer", in obtaining sufficient information on their customers to determine interconnectedness.
- 8.8 There may be situations where a counterparty is linked to more than one group of connected counterparties. Such situations may arise, where:
- (a) a counterparty is controlled by two equal partners that hold 50:50 participation and exercise equal control over the counterparty;
 - (b) a counterparty that is a partner in one or more partnerships also exercises control over these partnerships;
 - (c) a counterparty is dependent on a sole supplier for its business output (economic dependence) and is also solely dependent on its parent for financial assistance; and
 - (d) a counterparty who is the sole supplier to a group of entities.

In such situations, the exposure must be aggregated in each of the counterparty groups.

9.0 Exposures Subject to the Single Counterparty Exposure Limit

- 9.1 The SCEL must apply to all exposures as defined under paragraph 5.1, notwithstanding the creditworthiness of the counterparties or the quality of any underlying security, except for the following:
- (a) exposures to, or explicitly and unconditionally guaranteed by, the Federal Government of Malaysia or the Central Bank of Malaysia⁸;
 - (b) exposures of an overseas branch or subsidiary of a Labuan bank to the sovereign government or central banks in the jurisdiction where it is located where the exposure is denominated in its local currency and held to meet the regulatory requirements imposed by the central bank in that jurisdiction;
 - (c) exposures to a multilateral development bank⁹;
 - (d) exposures to a licensed banking institution arising from interbank money market transactions;
 - (e) exposures arising from granting of intra-day facilities;
 - (f) exposures deducted in the calculation of a Labuan bank's Total Capital as specified in the *Guidelines on Risk-Weighted Capital Adequacy* (e.g. investments in unconsolidated banking and financial subsidiaries);
 - (g) exposures that are fully funded back to back with placement by head office or parent entity; and
 - (h) any other exposures as may be specified by Labuan FSA, subject to prior written approval being obtained from the Authority.

10.0 Methods of Measuring Exposures

- 10.1 For the purpose of determining compliance with the SCEL, exposures to a single counterparty must be measured in accordance with the applicable Financial Reporting Standards (FRS) as permitted by Labuan FSA, unless otherwise specified.
- 10.2 **On-balance sheet exposures**¹⁰ must be measured in accordance with the applicable FRS, unless otherwise specified.

⁸ For avoidance of doubt, this exclusion does not include exposures to entities established by the Federal Government of Malaysia (e.g. MOF Inc. Khazanah Nasional) or the Central Bank of Malaysia that are not guaranteed explicitly by the Federal Government of Malaysia or the Central Bank of Malaysia.

⁹ This includes the African Development Bank, the Asian Development Bank, the Caribbean Development Bank, Council of Europe Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Inter-American Development Bank, the International Finance Facility for Immunisation, the Islamic Development Bank, the Nordic Investment Bank and the World Bank Group.

¹⁰ For avoidance of doubt, the exposure amount must not be computed net of provisions.

- 10.3 For **off-balance sheet exposures**, the on-balance sheet credit equivalent amount shall be the nominal principal amount multiplied by a 100% credit conversion factor (CCF), except for the following:

Underwriting arrangements

- (a) a 50%¹¹ CCF will be applied for obligations under an on-going underwriting agreement and revolving underwriting facilities from the commitment date until 60 days after the issuance of the securities. Any remaining securities held after such period must be computed at their full value as an exposure to the issuer.
- (b) where the Labuan bank enters into a legally binding sub-underwriting agreement without recourse, the bank may record the amount of exposure net of the amount underwritten by the sub-underwriters. The exposures acquired by the Labuan bank that is a sub-underwriter under such arrangements must apply the treatment as specified in paragraph 10.3(a).
- (c) where there is a legally binding placement (sale) agreement with an investor between the commitment and the issuance date of the securities, the Labuan banks can substitute the exposure from the issuer to the investor. Where the investor (buyer) of the securities is a banking institution, the acquired exposures must be recorded by the banking institution at 100% CCF, as it constitutes a commitment to purchase.
- (d) Labuan bank must ensure that assurance from legal counsel has been obtained with respect to the legal enforceability of all the documentation involved in an underwriting arrangement and such documentation is subject to periodic reviews to confirm its on-going enforceability.
- 10.4 For exposures under **repurchase agreement and sell and buy back (SBBA) agreements**, Labuan banks shall compute:
- (a) an exposure to the issuer of the security pledged; and
- (b) the net amount due from the counterparty when the value of the security pledged is higher than the loan/financing value.
- 10.5 For exposures under **reverse repurchase agreement and reverse SBBA**s, Labuan banks should compute the amount due from the counterparty, which may be off-set by the value of the security pledged if it qualifies as an eligible collateral as specified in paragraph 10.7.
- 10.6 For **exposures to schemes with underlying assets** (e.g. investments in collective investment schemes and securitisation transaction), the exposures must be determined in accordance with the guidance specified in **Appendix IV**.

¹¹ This does not apply to bought deals which involve an outright purchase by the Labuan banks.

Collateralisation

10.7 For the purpose of compliance with the SCEL, exposures to a single counterparty may be reduced to the extent that it is secured by eligible collateral, as follows:

- (a) cash deposits¹² (including certificate of deposits or comparable instruments issued by the lending banking institution);
- (c) gold;
- (d) securities issued by the Federal Government of Malaysia or the Central Bank of Malaysia or multilateral development banks;
- (e) securities issued by a central bank (including any entity which performs the role of a central bank) or a central government of a sovereign country that is rated at least “A-” (or its equivalent) by an internationally-recognised credit rating agency; and
- (f) other collaterals as may be specified by Labuan FSA, subject to prior written approval being obtained from the Authority.

10.8 The recognition of eligible collateral specified in paragraph 10.7 is subject to the following conditions:

- (a) the collateral must be pledged for the entire life of the exposure;
- (b) the collateral must be marked-to-market and revalued at a minimum frequency of six (6) months;
- (c) all documentation used must be binding on all parties and legally enforceable in all relevant jurisdictions. Labuan banks are required to obtain assurance from legal counsel with respect to the legal enforceability of the documentation. All documentation shall also be subjected to periodic reviews to confirm its on-going enforceability;
- (d) the legal mechanism by which collateral is pledged or transferred must ensure that Labuan banks have the right to liquidate or take legal possession of the collateral in a timely manner in the event of default, insolvency or bankruptcy of the counterparty. Banking institutions must have in place clear and robust procedures to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed and that collateral can be liquidated promptly. Labuan banks must take steps to ensure legal enforceability of the collateral pledged at all times;
- (e) where collateral is held by a custodian, reasonable steps must be taken to ensure good custody and that the custodian segregates the collateral from its own assets; and
- (f) for Islamic banking exposures, collateral must be fully Shariah-compliant.

¹² Cash pledged includes *`urbūn* (or earnest money held after a contract is established as collateral to guarantee contract performance) and *hamish jiddiyyah* (or security deposit held as collateral) in Islamic banking contracts (for example, Ijārah).

- 10.9 A commitment to provide collateral shall not be recognised as eligible credit risk mitigation for the purpose of determining compliance with the SCEL.
- 10.10 When the exposure and collateral are held in different currencies, an adjustment shall be made to the collateral to take account of possible future fluctuations in exchange rates. A haircut, H_{FX} , shall be applied, as follows:

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

Where:

- G = Nominal amount of the collateral
 H_{FX} = 8% supervisory haircut for currency mismatch between the collateral and the underlying obligation

- 10.11 Recognition of a single collateral to cover multiple exposures of one or several counterparties (for example, a parent company provides a single collateral to cover the borrowings of several entities within its group) is only allowed for transactions entered into with the same banking institution and if collateral pledged is exclusive to that banking institution. In addition, Labuan banks must ensure that the collateral is of sufficient value to cover the aggregate value of all the exposures and conditions as specified in paragraph 10.8 are adhered to.

11.0 Compliance with the Single Counterparty Exposure Limit

- 11.1 The SCEL must be observed at all times. The requirements of this Guidelines shall be complied with at both the entity and group¹³ basis. Labuan banks must put in place appropriate procedures and processes to facilitate on-going compliance. This should include adequate monitoring and reporting mechanisms to ensure adherence to this policy.
- 11.2 Labuan FSA views any breaches to the SCEL as a serious matter. In the case where there is a breach of limit, Labuan bank is given a one (1) year period to rectify the breach. Should the breach continue to persist, the Labuan bank shall notify Labuan FSA on the breach together with an explanation on the causes of the breach and remedial actions taken or to be taken (with a proposed time frame) to bring the exposures within the SCEL. During the rationalisation period, the Labuan bank shall not increase its

¹³ Refers to the Labuan bank, its subsidiaries and associate entities.

exposures to the affected counterparty (including its connected counterparties). The detailed report should be submitted to:

Director
Supervision and Enforcement Department
Labuan Financial Services Authority
17th Floor, Main Office Tower
Financial Park Complex
Jalan Merdeka
87000 Federal Territory of Labuan, Malaysia

Telephone no.: 087 591 200
Facsimile no.: 087 453 442 / 413 328
Email: scel@labuanfsa.gov.my

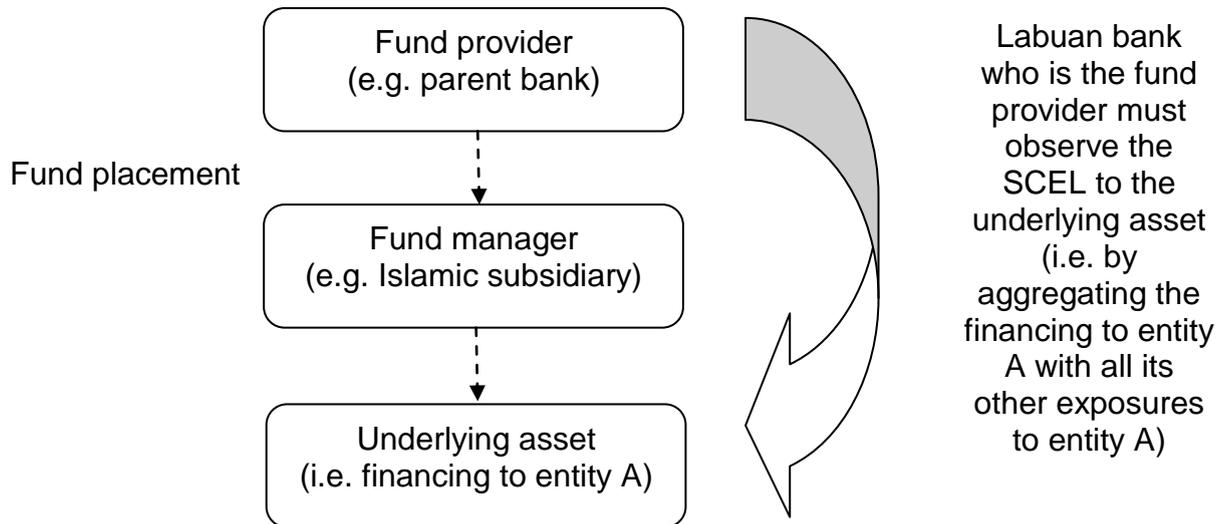
12.0 Transitional Arrangements

- 12.1 Labuan FSA recognises that Labuan banks will require time to fully comply with the requirements in this Guidelines. In particular, Labuan banks will need to review and confirm existing policies, procedures and internal limits, clarify roles and responsibilities, and undertake enhancements to existing systems to identify, measure, monitor, and aggregate exposures to single counterparties. Labuan FSA expects Labuan banks to initiate these efforts from 1 January 2014 but will allow time for the banks to demonstrate full compliance within one year from the effective date of the Guidelines.
- 12.2 All exposures whose terms have been agreed upon before the effective date of this Guidelines which are in breach of the SCEL based on the requirements specified herein are allowed to run to maturity.

Labuan Financial Services Authority
1 January 2014

APPENDIX I

Exposures Funded by Loss-bearing Funds



APPENDIX II

Determination of Power of Control

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

APPENDIX III

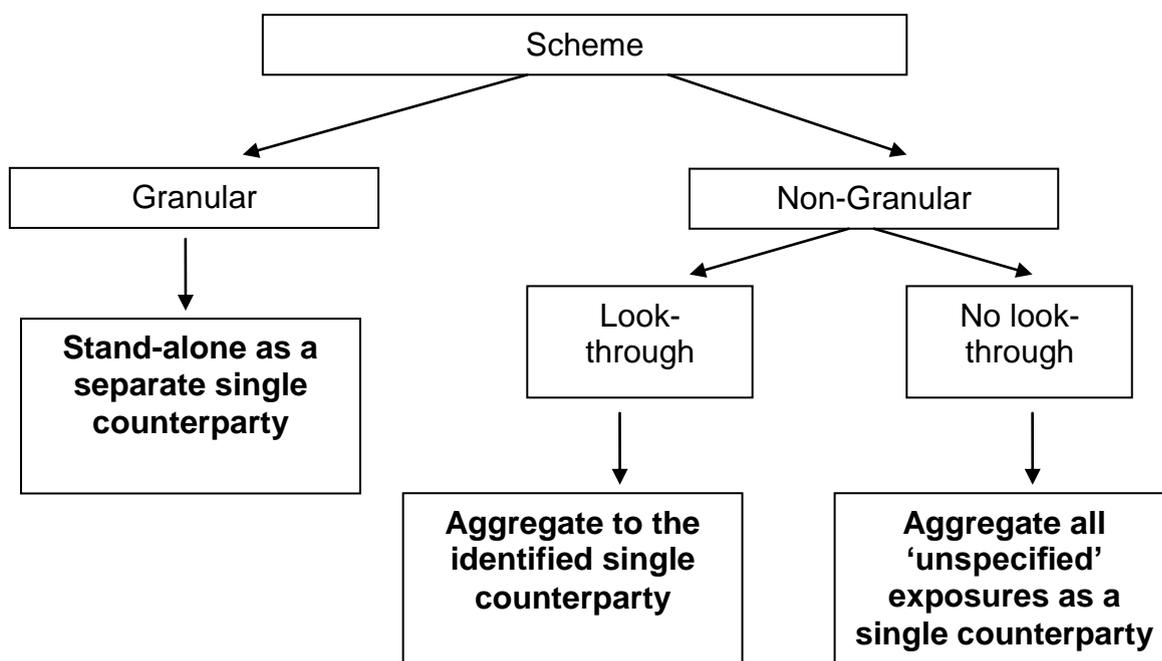
Determination of Connected Counterparties arising from Economic Dependence

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

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

APPENDIX IV

Method of Measuring Exposures to Schemes with Underlying Assets



1. Labuan banks must determine if the underlying assets in the scheme are granular. The scheme is considered granular when the largest exposure value of the underlying assets is equal to or less than 5% of the total value of the scheme, at the point of transaction. Exposures under each of such schemes may be treated as stand-alone exposures to a single counterparty.
2. If the underlying assets are not granular, banking institutions must apply the look-through approach and aggregate their exposures to the individual counterparty of the underlying pool of assets, subject to the ability to identify the issuers and value the assets at all times.
3. For exposures that qualify for the look-through approach, the exposure value must be aggregated to the issuer of each asset based on the relative size of the issuers' contribution to the scheme. For static portfolios where the underlying assets do not change over time, an assessment can be made once and does not need to be monitored in the future. For dynamic portfolios, monitoring must be carried out at regular intervals, at least every six (6) months.
4. If the banking institution is unable to look-through to the scheme, the exposures shall be classified as 'unspecified' exposures and aggregated with all other similar exposures arising from other schemes and regarded as a single counterparty.