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## PART A: INTRODUCTION AND OVERVIEW

### 1. Overview of the Guidelines

- 1.1 The revised Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes for Islamic Banks (the Guidelines) adopts a more principle-based regulatory approach in respect of equity-related activities to achieve the following principles and end-objectives:
- (i) allow greater flexibility for the management of Islamic banks to define the nature of equity-related activities to be undertaken;
  - (ii) promote improvements in risk management processes and development of prudent and sound practices to govern equity-related activities; and
  - (iii) support continuous enhancement with respect to regulatory and enforcement framework in order to curb excessive risk-taking amongst individual institutions for the purpose of maintaining the safety and soundness of the banking system.
- 1.2 The Guidelines move away from overly prescriptive requirements thus enabling Islamic banks to define the scope of their equity-related activities according to their capacity and capability. In this regard, Bank Negara Malaysia has put in place higher expectations on the oversight by the board and senior management of Islamic banks in ensuring the development of robust and comprehensive internal policies and procedures to govern the equity-related activities. For instance, while moving away from the “one-size-fits-all” limit structure on exposure to a single equity, the Guidelines expect senior management to determine their own internal limits and be held accountable for ensuring the effective compliance with such limits in safeguarding against concentration risk. More broadly, Bank Negara Malaysia would expect

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the board and senior management of Islamic banks to clearly articulate the institution's risk appetite and its relation to the Islamic bank's future business directions and risk management activities.

## **2. Definitions**

2.1 For the purpose of this guidelines, the following terms are defined as follows:

Equity-related activities : Investments in shares, interest-in-shares and collective investment schemes.

Share : Any equity of a corporation, whether with voting or non-voting rights.

Interest-in-share : Any right to purchase or receive shares of an entity, whether actual, prospective or contingent.

Collective investment schemes (CIS) : Any arrangement where it is made for the purpose, or having the effect, of providing facilities for persons to participate in or receive profits or income arising from the acquisition, holding, management or disposal of securities, futures contracts or any other property, or sums paid out of such profits or income. In such schemes, participants do not have day-to-day control over the management of the schemes' assets.

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Unit trusts : Collective investment schemes that are established as unit trust schemes under Section 2 of the Capital Markets and Services Act 2007.

### 3. Legal Enforceability and Application

- 3.1 The Guidelines are issued pursuant to section 53A of the Islamic Banking Act 1983 (IBA). The Guidelines shall supersede the circulars listed in **Appendix I** which are earlier issued by Bank Negara Malaysia.
- 3.2 The Guidelines shall be applicable to all Islamic banks licensed under section 3 (4) of IBA.

### 4. Scope of Guidelines

- 4.1 The Guidelines outline the following:
- (i) general parameters to guide Islamic banks' activities related to the investment in shares, interest-in-shares and collective investment schemes;
  - (ii) supervisory expectations on Islamic banks to ensure that the resultant risks are effectively managed; and
  - (iii) prudential requirements to avoid excessive risk-taking arising from equity-related activities.

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## PART B: BROAD PARAMETERS

### 5. Types of Allowable Investments

5.1 Islamic banks are allowed to invest in the following<sup>1</sup>:

- (i) shares or hold interest-in-shares of any corporation<sup>2</sup>:
  - (a) listed and unlisted shares;
  - (b) preference shares;
  - (c) shares of unrelated banking institutions (subject to conditions specified in paragraph 5.2);
  - (d) equity options, warrants or other forms of interest-in-shares; and
  - (e) any of the above categories of shares or interest-in-shares in foreign markets.
- (ii) CIS, including unit trusts (e.g. institutional funds, real estate investment trusts, property trust funds, exchange-traded funds).

5.2 Holdings of shares or interest-in-shares of unrelated banking institution are permitted, subject to the following conditions:

- (i) the shares or interest-in-shares in banking institution are held for trading, market making, arbitrage, hedging or other purposes, and not with the intention of gaining influence or control over the investee banking institution. Investments in unrelated banking institutions for strategic purposes are not allowed; and

<sup>1</sup> Pursuant to Section 3(5)(b) of the IBA, Islamic banks are required to ensure that all equity-related activities are in compliance with Shariah requirements, as endorsed by its Shariah committee.

<sup>2</sup> Includes shares or interest-in-shares exposures arising from Musharakah and Mudharabah contracts.

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- (ii) any holding of the shares of a domestic banking institution shall not exceed 5% of the investee's total ordinary share capital, unless prior approval from Bank Negara Malaysia has been obtained.

5.3 Islamic banks are allowed to acquire shares or interest-in-shares arising from the following:

- (i) satisfaction of debts (i.e. foreclosed shares)
- (ii) conversion of debt into equity<sup>3</sup>; and
- (iii) as a result of underwriting commitments.

## **6. Supervisory Expectations on Islamic banks**

6.1 Bank Negara Malaysia expects Islamic banks to have in place a sound control environment to govern their investment in shares, interest-in-shares and CIS. This should be underpinned by a strong risk culture that emphasises the important role to be played by the board and senior management in providing effective oversight of these activities.

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<sup>3</sup> Islamic banks shall refer to Appendix 2 for the specific requirements for debt-equity conversion arrangements.

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## Board Oversight and Senior Management Responsibilities

6.2 Bank Negara Malaysia expects the board to put in place clear policies and procedures to govern the Islamic banks' equity-related activities to be implemented by senior management. The policies which are approved by the board should be consistent with the organisation's broader business strategies, level of expertise, risk management capabilities and comply with Shariah principles. At minimum, Bank Negara Malaysia expects that the policies should cover the following:

- (i) Allowable investments for the Islamic bank covering:
  - (a) types of transactions (e.g. for trading, hedging or investment purpose);
  - (b) types of instruments that are permissible under Shariah (e.g. ordinary shares, preference shares, unlisted shares or unit trust funds);
  - (c) types of issuers (e.g. minimum quality or rating of issuer);
  - (d) target liquidity and duration of the investment portfolio (e.g. setting the minimum and maximum duration), having regard to its investment strategies and desired returns;
  - (e) allowable markets for investments. The policies on allowable markets should also reflect the management's views on the relative riskiness of various market segments which will guide or set the boundaries for which the relevant parties within the Islamic bank can develop suitable investment or product strategies. Such risk analysis should be documented and updated to reflect the prevailing macro-economic environment and possible future scenarios. For equities listed in stock exchanges,

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due consideration should also be given to the operation of circuit breaker mechanisms or other control features within the stock exchanges to manage extreme market volatilities.

- (ii) a set of clear criteria for the classification of the transactions into the trading or banking book consistent with the Trading Book Policy Statement required under the market risk component of the Capital Adequacy Framework for Islamic Banks (CAFIB) issued by Bank Negara Malaysia.
- (iii) internal portfolio diversification strategies and internal limits such as individual counter limits, market limits, industry sectoral limits and loss limits. The limits should reflect the level of risks and liquidity associated with particular shares, markets or sectors.
- (iv) clear lines of responsibility with effective reporting procedures. The policies should clearly indicate the decision-making authority and approval process, for new investments and limits overrides;
- (v) ensuring compliance to Shariah principles and requirements. The policies should clearly outline the duties and responsibilities of Shariah committee and officers pertaining to Shariah compliance matters. In principle, the document should provide adequate guidance to promote sound decision making, monitoring and assessment in respect of ensuring the status of the investment continue to be permissible under Shariah. In addition, the policies should also provide appropriate measures to address the potential of non-compliance to Shariah requirements; and
- (vi) clearly defined responsibilities of internal audit in assessing the effectiveness of the internal control systems put in place to

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control risk taking. This should include independent assessments by internal audit of the following:

- (a) state of the Islamic bank's compliance with investment policies and limits; and
- (b) the quality of the processes established to ensure adherence to policies and procedures set by the board and senior management, including reporting structures.

Bank Negara Malaysia expects the internal audit to undertake an assessment of the Islamic bank's control environment periodically and report its assessment to senior management and the board, together with recommendations to enhance the control procedures. The board and senior management should ensure that audit findings and recommendations are promptly acted on.

### **Risk Management Processes and Infrastructure**

6.3 To support the equity-related activities undertaken by each institution, Bank Negara Malaysia expects Islamic banks to have appropriate risk management processes and infrastructure that are consistent with sound risk management principles established under relevant guidelines issued by Bank Negara Malaysia. The board and senior management are responsible to ensure that robust processes and systems are put in place such that all material risks are clearly identified, measured and monitored to enable sound investment decision and avoid excessive risk exposures to equity positions.

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6.4 In particular, Islamic banks should have the following in place:

- (i) a robust measurement and valuation framework for both proprietary holdings as well as for positions held on behalf of client (i.e. collateral). This framework should be consistent with the valuation requirements under the market risk component of the CAFIB and other relevant guidelines and standards, including accounting standards;
- (ii) strong management information systems which facilitates the on-going monitoring of risks arising from equity related activities and the risk reporting requirements to the board and senior management. Such systems should enable Islamic banks to monitor actual risk taking against predetermined internal limits and risk tolerance levels. With respect to CIS, this includes the ability to aggregate material indirect exposures to single and connected entities across separate funds;
- (iii) a strong monitoring process that is supported by trigger mechanisms and clearly defined action plans in the event of limit breaches in order to mitigate a further deterioration of the portfolio; and
- (iv) a rigorous stress-testing framework, based on sound assumptions, incorporating periodical assessments of scenarios which could have adverse implications on the Islamic bank. Results of such stress testing should be considered in the context of the potential impact on overall capital adequacy of Islamic banks under plausible case scenario.

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### **Specific Requirements for investment in CIS Related Activities**

6.5 In investing in CIS, Bank Negara Malaysia expects Islamic banks to have conducted a thorough assessment of the CIS, which at minimum should cover:

- (i) the consistency of the investment objectives and risk profile of the fund with the Islamic bank's overall investment objectives and risk tolerance; and
- (ii) the quality of the fund manager, including a consideration of the level of expertise and the past performance of the manager.

6.6 It is important that appropriate and effective controls are instituted to enable Islamic banks to continually assess that the investments are conducted in a manner that is consistent with the Islamic bank's broader business strategies and within the boundaries defined by its risk management framework. This includes ensuring that fund managers provide adequate reports to Islamic banks:

- (i) on underlying investments, the extent of leverage and fund performance of individual CIS on a periodic basis; and
- (ii) whenever there are any material changes to the way the fund is managed, which could invalidate the suitability of investing in the CIS.

6.7 Islamic banks should also assess and manage the risks associated with sponsorships of CIS appropriately. Such sponsorships may take place directly, through injections of seed capital into funds or the provision of liquidity support facilities. In addition, implicit sponsorships of CIS also exist, when for example, CIS are marketed under the label/franchise of the financial group in which the Islamic bank belongs. Where such sponsorship exist, Islamic banks should ensure that

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adequate processes are in place to manage exposures arising from both the Islamic banks' contractual commitments as well as reputational risks to the Islamic banks.

## **PART C: PRUDENTIAL REQUIREMENTS**

### **7. Aggregate Limits**

7.1 An Islamic bank's investment in shares, interest-in-shares and CIS shall be subject to the following limits:

- (i) the aggregate book value of investment in shares, interest-in-shares, CIS and immovable properties<sup>4</sup> shall not exceed 50% of the Islamic bank's capital base; and
- (ii) the aggregate book value of the Islamic bank's investments in shares and interest-in-shares shall not exceed 25% of the Islamic bank's capital base.

7.2 The following categories of shares and interest-in-shares may be excluded from the computation of the limits specified in paragraph 7.1:

- (i) investments in shares and interest-in-shares which are deducted from capital base;
- (ii) shares or interest-in-shares acquired as a result of underwriting commitments, from satisfaction of debts or from debt-equity conversions schemes provided the shares or interest-in-shares are held for a period no longer than the time frame stipulated in Table 1 as follows:

<sup>4</sup> Immovable properties cover the exposures defined in the Guidelines on Property Development and Property Investment Activities.

**Table 1**

<b>Shares or interest-in-shares acquired under the following circumstances:</b>	<b>Allowable period for shares or interest-in-shares to be excluded from 25% overall limit</b>
<ul style="list-style-type: none"> <li>▪ Satisfaction of debts</li> <li>▪ As a result of underwriting commitments</li> </ul>	12 months from date of acquisition of the shares or interest-in-shares
<ul style="list-style-type: none"> <li>▪ Conversion of debt into equity</li> </ul>	5 years from date of acquisition of the shares or interest-in-shares

Shares or interest-in-shares that are held after the expiry of the stipulated time frame shall be included within the limits prescribed under paragraph 7.1 from the date of expiry of the stipulated periods;

- (iii) unquoted shares held in organizations which have been set up for socio-economic<sup>5</sup> purposes; and
- (iv) The exposures to equity-related activities that are funded by profit sharing investment account (PSIA) provided that Islamic banks satisfy the requirements specified in the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent.<sup>6</sup>

<sup>5</sup> Investment called for by the Government, Bank Negara Malaysia or the Banking Associations.

<sup>6</sup> Qualifying exposures to equity-related activities funded by PSIA placement by parent banking institutions shall be accounted for in the prudential limits computation of the parent banking institutions.

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7.3 Islamic banks may exclude shares or interest-in-shares which are fully-hedged or which are held to hedge equity derivative exposures from the 25% overall limit, subject to the following conditions:

- (i) the shares or interest-in-shares can be specifically identified and matched to the underlying exposure of the equity derivative<sup>7</sup>, which is not already offset in whole or in part, by other financial instruments; and
- (ii) it must be probable both at the inception and throughout the duration of the investment that a high degree of negative correlation exists between changes in the value of the shares or interest-in-shares exposure and changes in the value of the equity derivative.

7.4 In addition, Islamic banks should also ensure that the limit on overall exposure to a single counterparty as may be specified by Bank Negara Malaysia is strictly observed.

7.5 Islamic banks are also required to obtain approval from Bank Negara Malaysia for the establishment or acquisition of a subsidiary<sup>8</sup>.

## **8. Capital Adequacy Requirements**

### **Market and Credit Risk**

8.1 Islamic banks are required to classify all equity positions into either the trading or banking book based on the intention in undertaking the investment and other considerations which have been specified under

<sup>7</sup> For holding of shares to hedge call warrants issued by the banking institution, shares that are held in excess of its potential delivery obligations or shares that are held against expired warrants that have not been exercised shall be subjected to the overall limit of 25%.

<sup>8</sup> Please refer to the circular on Establishment of Subsidiary by Islamic Banks issued by Bank Negara Malaysia on 30 September 2005.

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the market risk component of CAFIB. In addition, Islamic banks shall refer to CAFIB for the purpose of assigning appropriate capital adequacy treatment on its equity positions.

- 8.2 Islamic banks may exclude the market and credit risk weighted assets assigned to exposures on equity-related activities that are funded by PSIA for the purpose of risk weighted capital ratio (RWCR) calculation provided that the requirements specified in the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent are satisfied.

### Large Exposure Risk Requirements

- 8.3 A capital charge for Large Exposure Risk Requirements (LERR)<sup>9</sup> shall be applied to ensure Islamic banks that have substantial exposures to a single counter would allocate sufficient capital to mitigate any adverse implication arising from the movement in the price of particular counter. In this regard, Islamic banks shall make reference to CAFIB for further details on determining LERR capital charges.

## 9. Non-Compliance

- 9.1 Bank Negara Malaysia reserves the right to impose additional restrictions, limits, conditions or take other actions<sup>10</sup> as may be deemed fit in respect of an Islamic bank's failure to satisfactorily meet supervisory expectations and requirements under the Guidelines, or where Bank Negara Malaysia otherwise has reason to believe that the Islamic bank's equity-related activities are not being effectively managed.

<sup>9</sup> Islamic banks shall be subject to LERR capital charge on an on-going basis if an exposure to a single equity exceeds either 15% of the Islamic bank's capital base or 10% of the issuer's paid up capital, whichever is lower.

<sup>10</sup> Including imposing individual counter limits, reducing the overall limit, and restricting the types of investments that the Islamic bank can undertake.

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## APPENDIX 1: SPECIFIC REQUIREMENTS FOR DEBT-EQUITY CONVERSION ARRANGEMENT

### A. Eligibility

1. All Islamic banks are eligible to participate in the debt-equity conversion scheme of any corporation incorporated under the Companies Act 1965.

### B. Approval from Bank Negara Malaysia

2. Approval is granted for Islamic banks to participate in debt-equity conversion schemes which would result in the Islamic bank holding the shares of the restructured corporation. However, such shares should not be more than 33% of the restructured corporation's paid-up capital.
3. Nevertheless, Islamic banks are required to notify Bank Negara Malaysia at least one month before entering into any agreement for participation in any debt-equity conversion scheme, the details of the scheme, as follows:
  - (i) brief background information on the debtor/investee;
  - (ii) amount of debt to be converted and its proportion to total outstanding debt of the Islamic bank;
  - (iii) number of shares to be issued to the Islamic bank and its proportion to the restructured share capital of the debtor/investee;
  - (iv) proposed shareholding in the debtor/investee as a percentage of the Islamic bank's shareholders' funds; and

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(iv) other information and statistics which may be relevant.

4. Islamic banks are still required to obtain prior approval of Bank Negara Malaysia in relation to debt-equity conversions which involve equity holding in excess of 33%. The application for approval should provide the information in paragraph 3 above.

### **C. Additional Equity Injection**

5. Prior approval from Bank Negara Malaysia is required for further injection of new equity by the Islamic bank into an ailing company to assist in the rehabilitation process in addition to the equity acquired through debt-equity conversion. However, the existing and additional equity stake should not, in aggregate, exceed 33% of the nominal paid-up capital of the investee. Nevertheless, a higher equity stake may be allowed on a case-by-case basis.

### **D. Credit Facility to the Restructured Corporation**

6. An Islamic bank with an equity stake in a restructured corporation is allowed to nominate its director or staff as a non-executive director of the corporation, for purposes of protecting the Islamic bank's interest arising from existing financing extended to these corporations. Islamic banks are, however, prohibited from entering into new/additional credit transactions with the corporation concerned.<sup>11</sup>

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<sup>11</sup> Refer to "Guidelines on Credit Transactions and Exposures with Connected Parties for Islamic Banks".

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**E. Treatment of Financing that are Converted into Equity Instruments**

7. Islamic banks shall refer to the Guidelines on Financial Reporting for Licensed Islamic Banks (BNM/GP8-i) for treatment of financing that have been converted into equity instruments.

**F. Approval of Other Regulatory or Supervisory Authorities**

8. Where approval of other regulatory authorities is required for any debt-equity conversion scheme, the financial adviser has to ensure that such approval is duly obtained.