



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Trade Credit Insurance and Trade Credit Takaful Exposure Draft

Applicable to:

1. Licensed insurers
2. Licensed takaful operators
3. Licensed Islamic banks
4. Licensed banks
5. Licensed investment banks
6. Licensed banks and licensed investment banks carrying on Islamic banking business
7. Financial holding companies

This exposure draft (ED) sets out the Bank's proposed requirements on the offering of trade credit insurance and trade credit takaful. It also clarifies the treatment of trade credit insurance and trade credit takaful as credit risk mitigation under the Capital Adequacy Framework for banking institutions.

The Bank invites written comments on this exposure draft, including suggestions for particular issues/areas to be clarified or elaborated further and any alternative proposals that the Bank should consider. To facilitate the Bank's assessment, please support each comment with a clear rationale, accompanying evidence or illustration, as appropriate.

In addition to providing general feedback, insurers, takaful operators and banking institutions are requested to provide feedback on the questions in this exposure draft and the data template attached.

Responses to the ED and the completed quantitative impact surveys must be submitted to the Bank by **16 July 2018** to—

Pengarah
Jabatan Perbankan Islam dan Takaful
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur

In the course of providing your feedback, you may direct any queries to Nurul Iman Azwan at nuruliman@bnm.gov.my.

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PART A OVERVIEW

1. Introduction

- 1.1 Trade credit insurance and trade credit takaful protect businesses against the risk of non-payment of goods and services by buyers. Such insurance and takaful can also help businesses manage country risk and thus opens up access to new markets. For financial institutions, trade credit insurance and trade credit takaful can also be used to manage risks of their trade financing portfolios.
- 1.2 This policy document aims to clarify the approval process and other requirements for the offering of trade credit insurance and trade credit takaful by licensed insurers and takaful operators respectively. It also sets out the treatment of trade credit insurance and trade credit takaful as credit risk mitigation (CRM) under the Capital Adequacy Framework for banking institutions.

2. Applicability

- 2.1 This policy document is applicable to licensed insurers, licensed takaful operators and financial institutions as defined in paragraph 5.2.

3. Legal provisions

- 3.1 The requirements in this policy document are specified pursuant to—
- (a) sections 14(3), 47(1), 115(3) and 143(2) of the Financial Services Act 2013 (FSA); and
 - (b) sections 15(3), 57(1), 127(3) and 155(2) of the Islamic Financial Services Act 2013 (IFSA).
- 3.2 The guidance in this policy document is issued pursuant to section 266 of FSA and section 277 of IFSA.

4. Effective date

- 4.1 This policy document comes into effect upon the issuance of the final policy document.
- 4.2 The Bank is committed to ensure that its policies remain relevant and continue to meet the intended objectives and outcome. Accordingly, the Bank will review this policy document within five years from the date of issuance or the Bank's last review and, where necessary, amend or replace this policy document.

5. Interpretation

- 5.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the IFSA and the FSA, as the case may be, unless otherwise defined in this policy document.

5.2 For the purpose of this policy document–

“**S**” denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretative, supplemental and transitional provisions that must be complied with. Non-compliance may result in enforcement action;

“**G**” denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted;

“**Capital Adequacy Framework for banking institutions**” collectively refers to the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets).

“**financial institution**” refers to–

- (a) a licensed bank;
- (b) a licensed investment bank;
- (c) a licensed Islamic bank, except for a licensed international Islamic bank; and
- (d) a financial holding company approved pursuant to section 112(3) of the FSA or section 124(3) of the IFSA and holds investment directly or indirectly in corporations that are engaged predominantly in banking business.

“**trade credit insurance or trade credit takaful**” refers to insurance or takaful cover that protects sellers against the risk of non-payment of goods and services by buyers.

6. Related legal instruments and policy documents

- 6.1 This policy document must be read together with other relevant legal instruments and policy documents that have been issued by the Bank, in particular–
- (a) Capital Adequacy Framework (Basel II – Risk-Weighted Assets); and
 - (b) Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets).

7. Policy documents superseded

- 7.1 Paragraph B of the circular on Pengeluaran Bon/Jaminan Kewangan oleh Penanggung Insurans (BNM/RH/CIR/003-7) issued on 11 August 2007 is superseded by this policy document.

PART B POLICY REQUIREMENTS

8. Offering of trade credit insurance and trade credit takaful

- 8.1 Section 14(3) of the FSA and section 15(3) of the IFSA stipulate that except with the prior written approval of the Bank, a licensed insurer or takaful operator shall not carry on trade credit insurance business or trade credit takaful business¹.
- S** 8.2 To offer trade credit insurance or trade credit takaful, as the case may be, a licensed insurer or takaful operator must have adequate technical capability to underwrite credit risk. This capability will be assessed by the Bank before the licensed insurer or takaful operator is allowed to carry on such business.
- S** 8.3 In relation to paragraph 8.2, where a licensed insurer or takaful operator enters into a collaboration with a foreign institution to offer trade credit insurance or trade credit takaful, as the case may be, the licensed insurer or takaful operator must ensure that there is a clear and structured plan to develop its own underwriting expertise.
- S** 8.4 A licensed takaful operator must ensure that it offers trade credit takaful in a Shariah compliant manner.
- S** 8.5 For purposes of obtaining the Bank's prior written approval under section 14(3) of the FSA or section 15(3) of the IFSA to carry on trade credit insurance or trade credit takaful business, as the case may be, a licensed insurer or takaful operator shall apply in writing for such approval and shall submit the information required in **Appendix 1** together with its application to the Bank.
- S** 8.6 Unless otherwise specified by the Bank, the annual gross premiums or contributions of trade credit insurance or trade credit takaful business must not exceed 10% of a licensed insurer or takaful operator's total gross premiums or contributions of the preceding calendar year as illustrated in **Appendix 2**.
- S** 8.7 A licensed insurer which was approved to carry on trade credit insurance business pursuant to the circular on Pengeluaran Bon/Jaminan Kewangan oleh Penanggung Insurans shall be deemed to be approved under section 14(3) of the FSA. For the avoidance of doubt, such a licenced insurer need not apply to the Bank for any further approval under section 14(3) of the FSA nor submit the information required under paragraph 8.5.

Question 1

The purpose of limiting the size of trade credit insurance and trade credit takaful business in paragraph 8.6 is to restrict the risk exposure that could adversely affect

¹ On the basis that credit guarantee insurance business or credit guarantee takaful business includes trade credit insurance business or trade credit takaful business.

the stability of the licensed insurer or takaful operator, and its insurance or takaful funds.

Please comment on the appropriateness of the threshold and the formula as illustrated in **Appendix 2**. Where appropriate, please suggest an alternative approach to setting a prudential limit for this business.

9. Treatment of trade credit insurance and trade credit takaful by financial institutions

- G** 9.1 A financial institution may recognise trade credit insurance or trade credit takaful as CRM under the Capital Adequacy Framework for banking institutions.
- S** 9.2 Where a financial institution recognises trade credit insurance or trade credit takaful as CRM under the Capital Adequacy Framework for banking institutions, the financial institution must ensure that the trade credit insurance or trade credit takaful satisfies the guarantee requirements under Part B.2.5 or Part B.3.4, as the case may be, of the Capital Adequacy Framework.

Modifications to the Capital Adequacy Framework for banking institutions

1. To ensure that the trade credit insurance or trade credit takaful functions as a qualifying guarantee that satisfies the CRM requirements under the Capital Adequacy Framework, a financial institution must demonstrate to the Bank that the trade credit insurance or trade credit takaful meets the requirements concerning guarantees.
2. Accordingly, CRM will be recognised only when:
 - (a) the relevant requirements concerning guarantees in Part B.2.5 of the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Part B.3.4 of the Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets) are met. In addition, the financial institution must–
 - (i) establish policies and procedures to minimise the risk of delay and non-payment of claims, which include the following:
 - (A) determination and verification of the completeness and appropriateness of documentation or information required for submission to the trade credit insurance or trade credit takaful provider;
 - (B) monitoring of specified deadlines and credit standing of obligors; and
 - (C) timely and regular communication between the financial institution and the trade credit insurance or the trade credit takaful provider;
 - (ii) ensure that protracted default² of an obligor (*i.e.* the buyer of the referenced trade transaction in the trade credit insurance policy or

² Failure by the obligor to pay debt upon a pre-defined period, for whatsoever reason.

- trade credit takaful certificate) is included as a risk event eligible for protection³; and
- (iii) have obtained external legal opinion confirming that the unconditionality⁴ and irrevocability⁵ requirements for CRM recognition under the Capital Adequacy Framework are fulfilled; and
- (b) the provider of the trade credit insurance or trade credit takaful is a licensed insurer or takaful operator.
3. Where the trade credit insurance or trade credit takaful is ceded to a reinsurer or retakaful operator, a financial institution may recognise the reinsurer or retakaful operator's credit ratings or equivalent probability of default (PD) as if it were a direct claim in calculating the risk-weighted assets for the portion of exposure covered by the reinsurer or retakaful operator. To be deemed as a direct claim on a protection provider, this would be subject to the following conditions:
- (a) The reinsurer or retakaful operator is rated at least BBB- or has a PD equivalent to or lower than that associated with an external BBB- rating in the case where the financial institution adopts Internal Ratings Based Approach; and
 - (b) The reinsurance or retakaful contract–
 - (i) fulfils the guarantee requirements under the Capital Adequacy Framework;
 - (ii) provides an equally robust level of protection⁶ as the trade credit insurance policy or trade credit takaful certificate between the financial institution and the trade credit insurance or trade credit takaful provider; and
 - (iii) includes specific clause in the legal documentation that enables the financial institution to directly pursue claims payment from the reinsurer or retakaful operator upon the insurer or takaful operator default, for whatsoever reasons, in paying claims.

Part B.2.5 and Part B.3.4 of the Capital Adequacy Framework will be revised to incorporate the above changes.

³ For the avoidance of doubt, default of a single exposure in a portfolio covered by trade credit insurance or trade credit takaful should also be eligible for protection to the financial institution.

⁴ Unconditional means no exclusion clause or provisions outside the financial institution's control that prevents the licensed insurer or takaful operator from being obliged to pay out in a timely manner in the event that the obligor fails to make the payment due. Refers to paragraphs 2.142(iii) and 2.144(iii) of the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets), respectively.

⁵ Irrevocable means no clause that allows the licensed insurer or takaful operator to unilaterally cancel the trade credit insurance or trade credit takaful or increase the effective cost of cover as a result of deteriorating credit quality of the protected exposure. Refers to paragraphs 2.142(ii) and 2.144(ii) of the Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets), respectively.

⁶ To the extent possible, must include similar terms as per the trade credit insurance policy or trade credit takaful certificate between the financial institution and the licensed insurer or takaful operator. For example, the reinsurance or retakaful contract must give similar effect of the risks covered, exclusions and claims payment timeline as in the insurance policy or takaful certificate.

Question 2

- (a) What are the clauses that can affect the trade credit insurance policy or trade credit takaful certificate to be irrevocable and unconditional? To what extent can exclusion clauses or requirements under a trade credit insurance policy or trade credit takaful certificate be modified or eliminated to fulfil the requirements on unconditionality and irrevocability?
- (b) To what extent would the requirement to obtain an external legal opinion to confirm that the trade credit insurance or trade credit takaful is unconditional and irrevocable onerous? Please explain, including to elaborate on, where relevant, the costs and challenges involved in getting an external legal opinion.
- (c) What other measures can be used to minimise the risk of delay or non-payment of claims on trade credit insurance or trade credit takaful?
- (d) In an arrangement where the seller or exporter is the policy owner with the financial institution as beneficiary (e.g. loss-payee clause), how can a financial institution ensure that claims are paid in a timely manner? Are there sufficient safeguards which would justify the trade credit insurance or trade credit takaful arrangement qualifying as CRM? Please explain.
- (e) What are the potential risk of non-payment or delay of claims payment by the reinsurer or retakaful operator to the financial institution? What safeguards can be put in place to mitigate such risks?

Quantitative impact surveys

Licensed insurers and takaful operators are required to fill-up Attachment 1: Data on offering of trade credit insurance or trade credit takaful. Financial institutions are required to fill-up Attachment 2: Data on purchase of trade credit insurance or trade credit takaful.

APPENDICES

Appendix 1 Submission requirements on trade credit insurance and trade credit takaful business

1. Product name and description;
2. Product benefits;
3. Target product launch date;
4. Proposed distribution channel(s) and target market;
5. Premium or takaful contribution and charges;
6. Targeted yearly business volume;
7. Underwriting criteria and appetite for credit assessment, e.g. obligor with rating A or equivalent, exposure to specific industry/sector etc.;
8. Plans to enhance internal underwriting expertise;
9. Impact to reserving and capital position, including capital required, capital available and capital adequacy ratio;
10. Proposed risk monitoring and control of key product risks identified;
11. Details of proposed reinsurance/retakaful arrangement;
12. Description on the collaboration with foreign insurers/takaful providers (if applicable) including the areas of support which the providers will be providing e.g. human resource, systems software etc.; and
13. In the case of a takaful operator–
 - (a) product structure, including diagrams or transaction flows;
 - (b) type(s) of Shariah contract used;
 - (c) relevant resolution by the Shariah Advisory Council of Bank Negara Malaysia (SAC) that approved the product structure⁷;
 - (d) deliberation by the Shariah committee, including–
 - (i) Shariah issues arising from the product (if any);
 - (ii) issues on *takyif fiqhi* (fiqh adaption) and relevant documents presented for deliberation of the Shariah committee which include fiqh literature, evidence and reasoning supporting the Shariah compliance of the product;
 - (iii) the appropriate current Shariah ruling and/or recognised Shariah standard (if any); and
 - (iv) minutes of the Shariah committee's meeting in respect of the product; and
 - (e) verification statement by the Shariah committee that the product structure does not attract any Shariah issue that has not been deliberated by the SAC. The statement must be signed off by the Chairman of the Shariah committee. In addition, the statement must include any dissenting views from any member of the Shariah committee and the Shariah committee's deliberation and conclusions reached on such views.

⁷ For products that are subject to the SAC's prior approval or resolution, submission of information for such products shall be made after obtaining approval or resolution of the SAC.

Appendix 2 Illustration of the computation of limit on the size of trade credit insurance and trade credit takaful business

$$\begin{array}{|l} \text{Business Limit of Trade Credit} \\ \text{Insurance or Trade Credit} \\ \text{Takaful Business,} \\ \text{from January to December} \\ \text{2018} \end{array} = 10\% \times \begin{array}{|l} \text{Total Gross Premiums or} \\ \text{Contributions,} \\ \text{from January to December} \\ \text{2017} \end{array}$$