



Implementation Instructions Basel II Framework

Pillar 1 Standardized Approach for Credit Risk, Market Risk & Basic Indicator Approach for Operational Risk

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<u>Chapter 1: Definitions: -</u>		
1) QCB	Qatar Central Bank	
2) Department	Banking Supervision Department	

<p>3) Basel II Framework</p>	<p>The International Convergence of Capital Measurement & Capital Standards – A Revised Framework, popularly known as Basel II Framework relating to calculating capital adequacy, issued in June 2004 as updated vide its most recent document issued in June 2006, and other related documents/guidance notes issued by Basel Committee from time to time.</p> <p>Reference in this Instructions relating to Basel II framework would be “International Convergence of Capital Measurement and Capital Standards – A Revised Framework, Comprehensive Version issued in June 2006”. This document is available on www.bis.org under Basel Committee publications.</p>
<p>4) Capital Adequacy</p>	<p>The components of capital retained to meet potential risk of all sorts would be constituted of three tiers.</p> <p>Core Capital (Tier 1)</p> <p><u>Comprises of</u></p> <p>Permanent shareholders' equity (paid-up capital) (+) legal reserve (+) general reserve or other reserves (+) retained earnings <u>[Retained earnings should be as per the audited financial statement at year end and should remain the same for the entire financial year]</u></p> <p><u>Less</u></p> <ul style="list-style-type: none">• Treasury shares (bank's own shares purchased)• Goodwill• Interim cumulative net losses, <u>if any, on a quarterly basis</u>• <u>which are reviewed by external Auditors</u> <p>Tier 2</p> <p><u>Comprises of</u></p>

	<p>Fair value adjustments (45% of positive fair value to be taken to Tier 2. Any negative fair value adjustments have to be fully deducted from Tier 2) (+) Asset revaluation reserve (up to 45% of the reserve may be taken to Tier 2) (+) risk reserve (subject to a maximum of 1.25% of total risk weighted assets) (+) Subordinated debt (limited to the maximum of 50% of Tier 1. Please see detailed guidelines for raising subordinated debt in the Annex.1).</p> <p>Tier 3</p> <p>Comprises of</p> <p>Short-term subordinated loans to meet market risk of original maturity for a period of two years maximum, such that their balance will not exceed 250% of the Tier 1 capital required for supporting market risk. The minimum conditions for Tier 3 capital are:</p> <ul style="list-style-type: none">• Be unsecured, subordinated and fully paid-up,• Has an original maturity of maximum two years• Not repayable or redeemable before the agreed repayment date and without the prior approval of QCB,• It should be subject to lock-in clause which stipulates that neither interest nor principal may be paid, even at maturity, if the minimum capital adequacy ratio falls below the prescribed limit, i.e. 10%.• It should not contain restrictive clauses. <p>Limits of Tier 2 & Tier 3 Capital</p> <ul style="list-style-type: none">• Subordinated Term Debt will be limited to maximum of 50% of Tier 1 Capital• Total of Tier 2 capital will be limited to a maximum of 100% of total Tier 1 capital• Tier 3 Capital will be limited to 250% of bank's Tier 1 capital that is required to support market risk. Accordingly a minimum of about 28.5% of market risk needs to be supported by Tier 1 capital. <p>Deductions from Capital</p> <ul style="list-style-type: none">• Deductions pursuant to "Scope of Application" of Basel II
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	<p>framework will be 50% from Tier 1 & 50% from Tier 2 capital.</p> <ul style="list-style-type: none"> While deduction from Tier 1 & 2 at 50% each, bank should ensure that in case Tier 2 is not sufficient to deduct the required amount, such amount (s) may be deducted from Tier 1 capital. <p>Limits of Tier 2 & 3, based on Tier 1 will be computed after deduction of goodwill and treasury shares, but before deduction of investments.</p>									
5) Standardized Approach	The endorsed approach by Qatar Central Bank for calculation of capital adequacy with respect to credit risk and market risk and the Basic Indicator Approach for operational risk.									
6) Government	Comprises all the state ministries, organizations and departments that are related to Ministry of Finance & Economy and have its guarantee for their financial obligation.									
7) Government Establishments	Establishments or organizations fully owned by the Government and independent financially and administratively, and that have independent balance sheets.									
8) Semi-Government Establishments	Establishments in which the Government is subscribing 50% or more.									
9) Multilateral Development Banks (MDBs)	These are multilateral banks having high ratings and satisfy the criteria provided by the Basel Committee under Paragraph 59 of the Framework at page 21. These MDBs carry risk weight equivalent to zero per cent.									
10) International Rating Establishments	<p>The ratings agencies are establishments that rate credit worthiness in terms of stability and capability to settle obligations.</p> <p>The eligibility criteria governing rating agencies would be applied in accordance with paragraphs 90 to 108, pages 27 – 31 of the Basel II framework.</p> <p>Long Term Mapping</p> <table border="0"> <thead> <tr> <th>S&P</th> <th>FITCH</th> <th>Moody's</th> </tr> </thead> <tbody> <tr> <td>AAA to AA-</td> <td>AAA to AA-</td> <td>Aaa to Aa3</td> </tr> <tr> <td>A+ to A-</td> <td>A+ to A-</td> <td>A1 to A3</td> </tr> </tbody> </table>	S&P	FITCH	Moody's	AAA to AA-	AAA to AA-	Aaa to Aa3	A+ to A-	A+ to A-	A1 to A3
S&P	FITCH	Moody's								
AAA to AA-	AAA to AA-	Aaa to Aa3								
A+ to A-	A+ to A-	A1 to A3								

	<p>BBB to BBB- BBB + to BBB- Baa1 to Baa3</p> <p>BB+ to BB- BB+ to BB- Ba1 to Ba3</p> <p>B+ to B- B+ to B- B1 to B3</p> <p>Short Term Mapping</p> <p>S& P FITCH Moody's</p> <p>A-1+, A-1 F1+, F1 P-1</p> <p>A-2 F2 P-2</p> <p>A-3 F3 P-3</p>
11) Subsidiaries	Companies, in which the bank subscribes to their capital by more than 50% in each company or has full control over its operations as defined in the Consolidated Supervision regulation issued by Qatar Central Bank.
12) Associates	Companies in which the bank subscribes to their capital by 20% to 50% in each company.
13) Retail loans	Retail Loans include consumer loans, credit card receivables, small loans given to individuals and small business facilities. Small business would be institutions with a balance sheet not exceeding QR 10 million. This is only an indicative limit to enable banks to exercise their judgment. The maximum aggregate limit for retail loans to a single customer will be QR 2.5 million, and if the retail loan is more than the limit, this will be categorized as per the type of the loan (e.g. mortgage or corporate). For the purpose of compliance with this threshold limit, the limit would mean sanctioned limit or the actual outstanding, which ever is higher, for all on-balance sheet and off-balance sheet items.
14) Residential Mortgage loans	Loans that are granted by the bank to its customers which are secured by

	<p>the collateral of residential property which is either self occupied or is generating rental income, <u>and the prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the residential mortgage. The residential property should be wholly mortgaged in favour of the bank.</u></p>
15) Commercial Mortgage Loans	<p>Commercial Mortgage loans granted by the bank to its customers with commercial real estate mortgage, <u>such as office buildings to let, retail space, multi-family residential buildings, (like residential towers or mixed use towers covering residential and commercial); industrial or warehouse space, hotels etc, where the prospects of repayment and recovery on the exposure depend primarily on the cash flows generated by the commercial mortgage.</u></p>
16) Past Due Loans	<p>Loans which are overdue for three months and more.</p>
17) Trading Book	<p>Book that incorporates the following:</p> <p>(i) <u>All financial investments categorized as Held for Trading and / or Available for Sale which are listed and marked to market.</u></p> <p>(ii) <u>Investments in real estate by Islamic Banks</u></p> <p>To be eligible for trading book capital treatment, financial instruments should be:</p> <ol style="list-style-type: none">1. Either free from restrictive covenants on their tradability or able to be hedged completely,2. And trading portfolio should be frequently and accurately valued and actively managed. <p><u>Accordingly, all financial instruments in Held for Trading and</u></p>

	<u>Available for Sale which are listed must be marked to market and evaluated regularly atleast on a monthly basis.</u>
18) Banking Book	All other assets that is not included in the Trading Book.

Chapter 2: Prudential Norms on Capital Adequacy

Scope of Application

- The capital adequacy norms shall be applicable to all national banks, both on a solo level, which is the whole bank with branches in the State of Qatar and its international branches, i.e. global position and a consolidated level, which means the bank and its subsidiaries, for capital adequacy purpose.
- The capital adequacy ratio shall not be less than 10% at all times, both on a solo and consolidated basis, in pursuance of the instructions of QCB.

Investments in banking, securities & other financial entities

- Subsidiaries as defined at Item 11, page no. 6 should be fully consolidated.
- In case of significant minority investments in Associates (as defined at Item 12 at page 6), banks will deduct the entire amount of investments from the capital funds of the bank.
- Equity investments less than 20% should be risk weighted according to its category as defined in this Instruction.
- Any reciprocal cross holding of bank capital of locally incorporated banks will be deducted from capital.

Significant investments in Commercial (Non-financial) entities

- In case of significant minority or majority investments in commercial (Non-financial) entities, the following threshold levels will be applied:
 - Investments higher than **5%** of the bank's capital **and reserves** for individual significant investment in commercial entity and **20%** of the bank's capital **and reserves** for the aggregate of such investments will be applied for deduction from capital. The amount to be deducted will be that portion of the investment that exceeds the materiality level indicated above.

- Investments below the above threshold level will be risk weighted according to its category as defined in this Instruction.

Investments in Insurance subsidiaries

- In case of bank's investments in **an insurance entity is in excess of 20% of the insurance company's capital, the entire investment**, in an insurance entity should be deducted from bank's capital base.
- In case of investments in insurance company's capital is less than or equal to 20%, the exposure should be risk weighted according to its category as defined in this Instruction.

Note: In case of equity investments below the threshold level as given in banking, securities & other financial entities, significant investments in commercial entities and insurance subsidiaries, the exposure should be risk weighted according to its category defined in the Instructions. Investments in AFS category which are under trading book will attract market risk. Investments in AFS that are under the banking book will attract a risk weight of 150%, as given under Item 12 – Financial Investments at Page 14.

B) Method of filling in capital adequacy (Prudential) Return

data entry for the on -balance sheet items:

Table (1)

Credit risk

Incorporation of balances from the balance sheet: The first column of this table has to be filled in for the on-balance sheet items and off-balance sheet items according to the monthly data.

<p>1) Claims on Qatar Government and Qatar Central Bank:</p>	<p>In local and foreign currency: Direct credit facilities are to be posted under this item in addition to government securities treasury bills along with balances at Qatar Central Bank, and will attract zero per cent risk weight.</p>
<p>2) Claims on GCC <u>Federal</u> governments</p>	<p>In local and foreign currency: All direct credit facilities, debt securities and treasuries representing claims on GCC <u>Federal Governments</u> will attract 0% risk weight.</p>
<p>3) Claims on Governmental Establishments (PSEs) (a) <u>Government Establishments (PSEs) Not functioning on commercial basis</u></p> <p>(b) <u>Government Establishments (PSEs) Functioning on commercial basis</u></p>	<p>To post under this item claims in local and foreign currencies of government establishments (PSEs) incorporated in the State of Qatar and also in GCC Federal Governments. Claims in local currency will be risk weighted at zero per cent. In case the funding is in foreign currency, then risk weight of 20% will be applied.</p> <p>To post under this item claims on government establishments (PSEs) owned by the Government of Qatar and GCC Federal Governments and functioning on commercial basis. These claims will be treated as corporates.</p>
<p>4) Claims on other <u>Federal</u> governments and central banks</p>	<p>To post under this item claims' balances whether that be in the national currency of the country or in foreign currencies, and take into account risk weight that corresponds with the risk weight of the credit rating for the country.</p>
	<p>To post under this item claims' balances whether in local currency or in foreign currencies, and apply risk weight equivalent to zero per cent.</p>

5) Claims on multilateral development banks (MDBs)	Banks are required to refer to Basel Committee's list of MDBs eligible for 0% risk weight. The list is subject to revision by the Committee from time to time. The eligibility criteria for 0% risk weight of MDBs is as per those given under paragraph 59, page 21 of Basel II framework.
6) Banks	Claims on banks should be assigned risk weight as per Option 2 of the Basel II framework, a preferential risk weight corresponding to one category higher, as given at paragraph 63, page 22 of the framework, subject to a floor of 20%.
7) Claims on Corporates	<p>Claims on corporates include the following:</p> <ol style="list-style-type: none">1. All Private Sector Entities2. Semi-Government / Institutions / Government Establishments (PSEs) owned by the Government of Qatar and GCC Federal Governments working on commercial basis3. Non-Federal Government / Semi-Government institutions of other countries4. All other retail loans exceeding the threshold limit of QR 2.5 million.5. Investment Companies / Finance Companies / Securities Companies <p><u>Claims on corporates will be risk weighted as per the ratings assigned by the recognised external credit rating agencies.</u></p>
8) Retail Loans	To incorporate under this item claims on all retail loans as defined at Item 13 at page no. 6. Retail loans will attract a risk weight of 75%.
9) Residential Mortgage Loans	To incorporate under this item claim secured by residential mortgage as defined at Item 14 at page 7. These exposures will attract a risk weight of 75%. QCB would evaluate the preferential risk weight based on the default experience of

	these exposures.
10) Commercial Mortgage Loans	To incorporate under this item claim on all commercial mortgage loans as defined at Item No 15 at page 7. These claims will attract a risk weight of 100%.
11) Past Due Loans	<p>To incorporate under this item the unsecured portion of any loan that is past due for three months and more, net of specific provisions, including partial write-offs, will be risk weighted as under:</p> <ul style="list-style-type: none"> ○ 150% risk weight when the specific or determined provisions are less than 20% of the outstanding loan balance, ○ 100% risk weight when the specific provisions or determined provisions range between 20% to 50% of the outstanding loan balance ○ 50% risk weight when the specific provisions or determined provisions are more than 50% of the outstanding loan balance. <p>For the purpose of defining the secured portion of the overdue loans, eligible collateral will be the same as used for credit risk mitigation purposes as given under Chapter 5 of this guideline.</p>
12) Financial Investments (which are not in the trading book)	<ol style="list-style-type: none"> 1. <u>Banks investments categorized under the Available for Sale (AFS) which are not listed and not marked to market will attract credit risk. Such investments will attract 150% risk weight.</u> 2. <u>All Held to Maturity investments will be risk weighted according to its asset categories given in the Instruction.</u>
13) Other Assets	<p>To incorporate the following under this item :</p> <p>A) Cash: includes cash balances at the bank whether in local or foreign currency would attract a risk weight of zero per cent.</p> <p>B) Gold: to incorporate under this item the gold balances</p>

	<p>owned actually by the bank and under its disposal, the risk weight would be zero per cent.</p> <p>C) Cash items under collection: To include under this item all cash items in the process of collection, and will be risk weighted at 20%.</p> <p>D) Others: under this item to incorporate other assets balances in the monthly position along with fixed assets, will be risk weighted at 100%.</p>
<p>Note: Banks to note that while computing claims, they have to exclude deferred profit or deferred interest, interest / profit in suspense and specific provisions which may be included in the outstanding of loan balances.</p>	
<p>Chapter 3: Data entry for the Off - Balance Sheet items:</p> <p>The following items would be incorporated in accordance with the defined categories and these items will be filled in as per the period of exposure indicated in the table.</p>	
1) The unutilized part of the credit facilities:	To incorporate under this item all unutilized credit facilities granted to clients and divided as per the tenor (less than a year / more than a year)
2) Documentary Credits	To incorporate under this item the uncovered part (net of cash margin) of the documentary credits of all types.
3) Performance Bond	To incorporate under this item the uncovered part (net of cash margin) of performance bond balances.
4) Other Guarantees	To incorporate under this item the uncovered part (net of cash margin) of all other guarantees balances
5) Interest Rates Contracts	They are financial derivative contracts against interest rate risk. To incorporate under this item derivative positions, whether for the purposes of trading or hedging, and it will be posted under three columns as follows: less than a year, from one year to two year, and more than two years; with regard to balances for more than two years, they will be posted in a detailed manner, each separately in a table.
6) Exchange Rates Contracts	They are financial derivatives contracts against exchange rate risk and balances of derivatives, whether for purposes of trading or for hedging are incorporated under three columns as follows:

	less than a year, from one year to two years, and more than two years; as for balances for more than two years, they will be incorporated in a detailed manner, each separately in a table.
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Chapter 4: Data entry in Table No. (2)

Vide this Table, the contingent liabilities balances are processed through conversion factors in respect of each of the items associated with the bank's operations from Table No. 1 to be converted to credit risk so as to conform with the items on the balance sheet as outlined in the following table: -

Description	Conversion factor
1- Unutilized part of the credit facilities	
- less than a year	20%
- more than a year	50%

1 – Documentary Credits	20%
2 – Performance Bonds and Bid Bonds	50%
3 – Acceptances & Financial Guarantees	100%

Note: All other off-balance sheet items not mentioned above should be treated as per the Basel II Framework specification as outlined under Paragraphs 82 to 89 on pages 26 and 27 of International Convergence of Capital Measurement & Capital standards, A Revised Framework, Comprehensive Version, June 2006. A copy is enclosed as ANNEX 1 for ready reference.

1 – Interest Rate Contracts	
(a) Less than a year	0.5%
(b) From one to two years	1%
(c) More than two years (increases each year by)	1%
2 – Exchange Rate Contracts	
(a) Less than a year	2%
(b) From one to two years	5%
(c) More than two years (increases each year by)	3%

Chapter 5: Data entry in table no. (3)

Table No. 3 incorporates the total of on-balance sheet items and off-balance sheet items, taken from Table 1 & 2. Credit conversion factors are applied to off-balance sheet items in Table 2. Adjustments for credit risk mitigation are incorporated to arrive at the net exposure after application of credit risk mitigation. The risk weights as applicable will be applied to the net exposures to arrive at risk weighted assets for credit risk.

Eligible collaterals for credit risk mitigation

General Principle

While accepting collaterals for the purpose of credit risk mitigation, banks should ensure that the guarantor should have a better rating than the counterparty.

Operational requirements for guarantees

A guarantee must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of cover is clearly defined and incontrovertible. The guarantee must be unconditional. In addition to the legal certainty, the bank must have right to receive payments from the guarantor without first having to take legal action in order to pursue the counterparty for payment. The guarantee is an explicitly documented obligation assumed by the guarantor. The guarantee should cover all types of payments the underlying obligor is expected to make under the documentation governing the transaction.

The following collaterals are eligible for recognition as credit risk mitigants under the simple approach:

- 1. Cash, as well as certificates of deposits, or any comparable instruments issued by the lending bank, and held by it as collateral from the counterparty.**
- 2. Debt securities / Capital guaranteed Islamic Sukuks issued or guaranteed by the Government of Qatar and GCC Federal Governments.**
- 3. Guarantees issued by the Government of Qatar and GCC Federal Government.**
- 4. Debt securities issued by other States having a rating of AAA to AA- or equivalent ratings (See Table at Page No. 5).**
- 5. Debt securities / capital guaranteed Islamic Sukuks and having AAA rating or equivalent ratings (See Table at Page No. 5), issued by banks or other financial entities,**
- 6. Short-term Debt securities / capital guaranteed Islamic Sukuks with at least A-3/P-3 or equivalent short-term rating (See Table at Page 6).**
- 7. Guarantees issued by Sovereign entities, which include Bank for International Settlements, International Monetary Fund, European Central Bank, European Community and Multilateral Development Banks as given in Basel II Framework**
- 8. Guarantees issued by Banks and financial institutions having a rating of AAA to AA- or equivalent rating (See Table at Page No. 5)**
- 9. Equity stock listed on the Doha Securities Market; recognised Stock Exchanges in GCC; and those listed in the Main Index of international Stock Exchanges**

Haircuts

Haircut refers to a discount on the full value of an asset as collateral after taking into consideration inherent risks that affect the volatility of the market price or value of the asset. It is commonly expressed in terms of a percentage by which an asset's value as collateral is reduced.

While using the above eligible collaterals for credit risk mitigation purpose, banks should apply the following haircut:

<u>Types of collateral</u>	<u>% of haircut</u>
<u>Item 1</u>	<u>0%.</u> <u>In the case of exposure in foreign currency, a</u> <u>20% haircut has to be applied, except in GCC</u> <u>currencies & US Dollar</u>
<u>Items 2 & 3</u>	<u>0%</u>
<u>Items 4 to 7</u>	<u>20%</u>
<u>Item 8</u>	<u>40%</u>
<u>Item 9</u>	<u>60%</u> <u>Additional 20% in case of securities in foreign</u> <u>currency, except those issued in GCC</u> <u>Currency & US Dollar</u>

All the above instruments are required to be revalued at least at monthly intervals.

Chapter 6: Data entry in Table No. (4)

2- Market risk calculation (Standardized Approach): -

Market risk comprises of the following risks: -

1. Interest rate risk related to the financial instruments that are incorporated in the Trading Book .
2. Risk of equity instruments positions relative to the financial instruments incorporated in the Trading Book.
3. Risk of foreign currency exchange rate at the bank
4. Commodity positions risk at the bank
5. Option contracts risk
6. Banks' Board of Directors must set up a policy for classifying investment portfolio and lay down policies that ensure compliance with this policy. Banks will not shift from one portfolio to another without notifying QCB and explaining the reasons therefore for requiring such shifting from one portfolio to another.
7. In order to determine the required capital to meet market risk, banks must comply with the items outlined in table (4) relating to calculation of market risk in the following manner: -

8. The specific risk is the risk of exposure to losses incurred by negative changes of debt instruments or securities as a result of factors relating to the issuer of the financial instruments.
9. General Market risk is the risk of exposure to losses resulting from negative variations in market rates.

2- Interest Rate Risk -Table (4-A-1)

The instruments covered by interest rate risk are illustratively (but not (exhaustively) the following:

1. Government Bonds / Securities
2. Commercial bonds
3. Deposit certificates
4. Treasury bills
5. Securities of floating interest rate

In accordance to these instructions, the required capital must be calculated to cover interest rate risk for all interest rate positions relating to the items in the trading portfolio, both in respect of on & off balance sheet items, except for interest rate risk relating to option contracts as they are calculated in market risk Table No. 4A.4

The required capital to cover interest rate risk represents the total of the capital that is required to cover the specific and general market risk.

3- Specific Interest Rate Risk

1. Upon measuring the capital required to cover specific risk in respect of both the long and short position, netting could be effected between them only for the positions with identical issues. The financial instruments are deemed identical when the issuer party source is one, and also when they possess the same preferential rights in case of liquidation, and when the currency used, the distributions, and the date of maturity are identical.

2. The specific risk that are related to the interest rates' position for the items incorporated in the balance sheet, whether it represents long positions or short positions, would be calculated as follows:

2.1. The market value for the debt instrument (x) specific risk charge outlined in the market risk table and which is classified according to the counterparties based on the remaining period of the financial instrument tenor in case of fixed interest rate or for the remaining period for settlement date of the interest in case of the

variable interest rate instruments.
3. Calculate the capital required to cover the specific risk for derivatives contracts in the following manner:
3.1. Derivatives like interest rate swaps, forward rate agreements (FRAs), foreign exchange contracts etc. are not subject to specific market risk
4. To incorporate total market value (total absolute values for the long and short positions) for financial instruments to be detailed based on the party committed for Settlement. In this connection, it is worthwhile to refer to the following: -
4.1. State of Qatar's financial instruments issued in Riyals and foreign currencies as also of GCC countries will be risk weighted at zero percent.
4.2. Other State's financial instruments in national currency of countries with classification ranging from AA- to AAA, would be risk weighted zero, whereas the countries with classification less than A, and have issued financial instruments in their national currency, would get the treatment of the financial instruments issued in foreign currencies, and would then get the risk weight according to international classification for each country.
4. <u>General Interest Rate Risk</u>
1. The general interest rate risk applies to the positions pertaining to the interest rates in the trading portfolio on and off balance sheet items.
2. To begin with, the bank must gauge the extent of its exposure to general interest rate risk by adopting the method of maturity date.
3. To calculate the capital necessary for covering general interest rate risk as per the maturity method, the bank must first specify maturity periods for each currency and distribute the long and short positions with the market value on the time periods and according to the coupon interest rate as stated in the market risk table.
4. Opposite positions, whether actual or notional, may be omitted from the maturity ladder provided they originate from the same issue with identical amounts and do not include the different issues even if issued by the same party. And the banks may exclude swap, forward and future operations and contracts and forward rate agreements for the positions of identical issues. And to clarify the method of computing general interest rate risk, we state the following:
4.1. The market value is to be distributed for all financial instruments in the trading portfolio, along with the remaining instruments exposed to the interest rate risk (such as the derivatives) over the zones and the time

periods stated in the market risk Table No. 2 (pertaining to the general interest rate risk) and the long and short positions are to be presented separately.

4.2. Values of the long and short positions are to be multiplied by risk coefficients to come up to the long and short positions risk weighted with risk weights.

4.2.1. Reciprocal positions for each time period: -

To be expressed in positive values, which is tantamount to the risk weighted long positions in a specific time period or the absolute value for the risk weighted short positions in the same tenor, whichever is less, and if it was processed with the time period for only a long position or short position, then the reciprocal position for this time period would equal zero.

4.2.2. Non-reciprocal positions for each time period: -

Resulting from net long risk weighted positions and the short risk weighted positions for each time period.

4.2.3. Risk weighted reciprocal positions as per the zone

For every time period inside the zone, there will be either a non-reciprocal risk weighted position resulting from a long position or non-reciprocal risk weighted position generated from a short position; for each zone, the following is to be taken into account:

Total of risk weighted non-reciprocal long positions pertaining to the zone or the absolute value for total of risk weighted non-reciprocal short positions, whichever is less.

In case all the time periods inside the zone contain long positions only or short positions only, zero value will be recorded on the grounds that it is the risk weighted reciprocal position for the zone.

4.2.4. Risk weighted non-reciprocal positions zone-wise

Total of long, short and risk weighted positions with risk weight for each zone is the non-reciprocal risk weighted position for this zone.

4.2.5. Reciprocal risk weighted positions between zones: -

Specification of the risk weighted reciprocal position between each two zones by conducting a regular reconciliation between the risk weighted non-reciprocal position for a zone against that pertaining to another zone; if one of them is long and the other is short, then comparison for the absolute values is carried out, and post whichever is less; whereas if the risk weighted non-reciprocal positions for each of the two zone is only long or only short, then zero value would be marked.

Total of capital required to cover general market interest rate risk represents total of the absolute values for

the following: -	
Total of absolute value for the reciprocal risk weighted positions in all time periods	10%
Risk weighted reciprocal positions in zone (1)	40%
Risk weighted reciprocal positions in zone (2)	30%
Risk weighted reciprocal positions in zone (3)	30%
Reciprocal positions between the two zones (1) & (2)	40%
Reciprocal positions between the two zones (2) & (3)	40%
Reciprocal positions between the two zones (1) & (3)	100%
The absolute value for net risk weighted non-reciprocal positions for the three zones	100%

5- Equity instruments risk – Table 4-A-2

To apply the capital required to cover the risk of the equity instruments on all positions of these securities incorporated in the trading portfolio with the exception of long positions in option contracts. These instruments are represented illustratively, not exhaustively, in the following:

1. Common shares
2. Transferable securities which can be treated as equity instruments
3. Depository receipts (must be transferred into shares and classified according to the country issuing these shares)
4. Any other instruments with equity characteristics or where the bank envisages that it bears its risk.
5. Equity instruments derivatives or the derivatives of above mentioned instruments.

To calculate the capital required for covering equity instruments risk, you have to classify firstly these instruments as per the country in which each instrument is listed, and with regard to the instruments listed in more than a country, one country is chosen, and the option must be used in a consistent manner.

The capital necessary to cover the equity instruments risk represents total of the following values: -

- 5.1. The capital necessary to cover the specific risk at the rate of 8% of the total absolute values for all the equity instruments positions generating from long or short transactions including the derivatives contracts calculated for each country separately.
- 5.2. The capital required to cover general market risk at the rate of 8% of the total absolute values for the net equity instruments positions calculated for each country separately.

Netting could be affected between the reciprocal positions for equity instruments or identical market indices in each country, which yields equity instruments positions resulting from buying or selling operations, on which the capital required for covering specific risk and the general market risk would be

applied.
To calculate the specific risk and the general market risk, the derivative contracts positions should be transformed into equity instruments positions according to the following:
5.2.1. Forward and future contracts related to equity instruments would be recorded at the market prices for an equity instrument
5.2.2. Future contracts associated with shares prices indices would be recorded at the market value.
5.2.3. Swap contracts relating to equity instrument are treated as two positions for investments.
<u>6- Exchange rate risk – Table 4-A-3</u>
1. Requirements of capital necessary for covering exchange rate risk to be applied on all exchange rate risk related to all bank activities and gold.
2. To calculate the capital required covering exchange rate risk, the position of each foreign currency and also gold is to be converted into Qatari Riyal.
3. To exclude net US dollar position upon calculating the capital required covering the exchange rate risk due to the fixed exchange rate of the US dollar against the Qatari Riyal.
4. The capital necessary to cover exchange rate risk represents 8% of the following:
5. Total of positions resulting from net long positions or net of short positions, whichever is higher.
6. Net gold position whether resulting from a long or short position.
7. Net position for each foreign currency and gold must represent total of the following values:
7.1. Net current position represents total assets minus total liabilities including interest and due charges evaluated in the intended currency.
7.2. Net forward and future position (total net value of forward and future contracts in addition to currency swap contracts which will not be incorporated in the net spot position for currencies)
7.3. Net future revenues and expenses which are not due yet and are fully covered.
All positions (spot, forward & futures) must be evaluated according to the prevailing rates by applying spot market rates, and consequently future currencies positions are not to be evaluated by using forward exchange rates in view of the fact that they reflect variations of the prevailing interest rates.
<u>8. Investment in Real Estate by Islamic Banks (For Trading & rent)</u>
<ul style="list-style-type: none">• <u>Investments in real estate by Islamic Banks are subject to market risk.</u>• <u>Banks are required to review / evaluate their investments in real estate atleast every year.</u>• <u>Banks are required to compute capital charge for such exposures as under:</u>
<u>15% (x) 12.5 (reciprocal of 8% capital adequacy ratio) = 187.5%</u>

Chapter 7 : Capital charge for operational risk:

To begin with, banks in Qatar shall compute the capital requirements for operational risk under the Basic Indicator Approach. Qatar Central Bank will review the capital requirement under the Basic Indicator Approach for general credibility.

The Basic Indicator Approach

Banks using the Basic Indicator Approach must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.

Gross Income is defined as under :

Net interest income plus net non-interest income. It is intended that this measure should: (i) be gross of any provisions (e.g. for unpaid interest); (ii) be gross of operating expenses, including fees paid to outsourcing service providers, *in contrast to fees paid for services that are outsourced, fees received by banks that provide outsourcing services shall be included in the definition of gross income*; (iii) exclude realised profits / losses from the sale of securities in the banking book; *realised profits / losses from securities classified as "held to maturity", which typically constitute items of the banking book , are also excluded from the definition of gross income* and (iv) exclude extraordinary or irregular items as well as income derived from insurance.

Banks are advised to compute capital charge for operational risk under the Basic Indicator Approach as explained under:

* Average of [gross income * alpha] for each of the last three financial years, excluding years of negative or zero gross income

* **Gross income = [net profit (+) provisions (+) interest in suspense during the year (+) operating expenses]**

LESS

[Profit or loss on sale of htm investments (+) income from insurance (+) extraordinary / irregular item of income].

* Alpha = 15 per cent

As no specific criteria for use of Basic Indicator Approach are set out in the Basel II framework, banks using this approach are encouraged to comply with the Basel Committee's guidance on *Sound Practices for the Management and Supervision of Operational Risk*, February 2003.

Data entry in operational risk table – Table (5)

The table has to be filled in for the following particulars to arrive at the Gross Income:

[net profit (+) provision (+) Interest in suspense for the year (+) operating expenses] Less [realized profit / losses from sale of securities in HTM and AFS category that is in the banking book (+) extraordinary or irregular items of income (+) income from insurance (+) collection of any previously written-off loans or income derived from disposal of real estate etc during the year].

With regard to Islamic banks and Islamic branches for commercial banks, net operation revenues are to be established after excluding the share of absolute investment deposits from net profit & loss.

Chapter 8: data entry in capital adequacy account table –table (6)

Vide this table the items eligible for capital funds as required by QCB will be incorporated in the Table. As for fair value adjustments, a discount of 55% will be applied to the difference between the book value and the market value to reflect the potential volatility in this form of unrealized capital. This should be applied on an aggregate net-basis (portfolio wise) for the purpose of calculating Tier 2 capital. The same discount factor is to be applied on the asset side on the difference between the market value and book value for the purpose of calculating risk weighted assets. Any negative fair value adjustments should be fully deducted from Tier 2. Asset revaluation reserves are shown in the balance sheet when banks revalue fixed assets from time to time in line with change in the market value. The risk reserve should not exceed 1.25% of the risk weighted assets.

The total risk weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 12.5 (i.e. reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of the risk weighted assets for credit risk. Banks are required to maintain a minimum Capital Adequacy Ratio of 10% on an on-going basis.

ANNEX 1 - OFF-BALANCE SHEET ITEMS

13. Off-balance sheet items

82. Off-balance-sheet items under the standardised approach will be converted into credit exposure equivalents through the use of credit conversion factors (CCF). Counterparty risk weightings for OTC derivative transactions will not be subject to any specific ceiling.

83. Commitments with an original maturity up to one year and commitments with an original maturity over one year will receive a CCF of 20% and 50%, respectively. However, any commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, will receive a 0% CCF.

83(i). Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances) will receive a CCF of 100%.

83(ii). Sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the bank will receive a CCF of 100%.

84. A CCF of 100% will be applied to the lending of banks' securities or the posting of securities as collateral by banks, including instances where these arise out of repo-style transactions (i.e. repurchase/reverse repurchase and securities lending/securities borrowing transactions). See Section II.D.3 for the calculation of risk-weighted assets where the credit converted exposure is secured by eligible collateral.

84(i). Forward asset purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain drawdown will receive a CCF of 100%.

84(ii). Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) will receive a CCF of 50%.

84(iii). Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) will receive a CCF of 50%.

85. For short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment), a 20% CCF will be applied to both issuing and confirming banks.

86. Where there is an undertaking to provide a commitment on an off-balance sheet item, banks are to apply the lower of the two applicable CCFs.

87. The credit equivalent amount of OTC derivatives and SFTs that expose a bank to counterparty credit risk is to be calculated under the rules set forth in Annex 4 of the Framework.

88. Banks must closely monitor securities, commodities, and foreign exchange transactions that have failed, starting the first day they fail. A capital charge to failed transactions must be calculated in accordance with Annex 3 of the Framework.

89. With regard to unsettled securities, commodities, and foreign exchange transactions, the Committee is of the opinion that banks are exposed to counterparty credit risk from trade date, irrespective of the booking or the accounting of the transaction. Therefore, banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis. Furthermore, when such transactions are not processed through a delivery-versus-payment (DvP) or payment-versus-payment (PvP) mechanism, banks must calculate a capital charge as set forth in Annex 3 of the Framework.

ANNEX 2

Detailed guidelines for issuing subordinated debt

Banks' Capital Raising Options – Subordinated term debt

Subordinated term debt comprises all conventional unsecured borrowing instruments subordinated to all other liabilities of the bank except the share capital as recognised under Qatar regulations. To be eligible for inclusion in Tier 2 capital, these instruments will be limited to a maximum of 50% of Tier 1 capital, and should fulfill the following minimum criteria:

1. **Maturity:** The subordinated debt must have a minimum term to maturity of over five years;
2. It should be **fully paid-up**;
3. **Subordination:** The term of the debt agreement should ensure that the claims of the lender are fully subordinated to those of the unsubordinated creditors. The subordination provisions should meet the following criteria:
 - The claims of the subordinated creditors should rank behind those of all unsubordinated creditors.
 - To the extent possible, creditors should waive their rights to set off amounts they owe the bank against the subordinated amounts owed to them by the bank.
 - The only events of default should be a) non-payment of any amount due and payable (principal and interest only) under the debt agreement, and b) the winding up of the institution or the borrower.
 - The remedies available to the subordinated creditor in the event of default in respect of the subordinated debt should normally be limited to:
 - a. Petitioning for winding up of the institution or the borrower.
 - b. QCB feels that there should be no blanket right to sue for unpaid amounts because this might enable subordinated creditors to obtain full payment through the courts shortly before the bank goes into liquidation, thus reducing the cash available to depositors. However, if it is legally impossible to limit the remedies available to lenders to those stated above, the lender may have the right to sue for unpaid principal which is due and payable under the debt agreement, provided the bank has an option to defer repayment for at least six months after the contractual repayment date. The bank should also have the option to defer interest payments until a dividend is paid. Moreover, an event of default should not accelerate the debt in the sense of weakening the subordination provisions or permitting repayment outside a winding-up.

- c. The debt agreement should expressly exclude all other remedies. A bank should always provide the QCB with written confirmation that it has received a legal opinion from its legal advisor stating that these subordination requirements have been met.

4. Applicable Law: The debt agreement should normally be subject to Qatari Laws. Other laws are acceptable, but only where it is necessary for the success of the issue. In cases where the debt is issued under overseas law, QCB should be satisfied that adequate degree of subordination can be achieved under the overseas law. The issuing bank should obtain an opinion in this regard from reputable and experienced lawyers in the concerned country.

5. Trigger clauses: The debt agreement should not contain any clause which might require early repayment of the debt (e.g. cross default clauses, negative pledges and restrictive covenants), or which might make the debt more expensive (i.e. a clause which leads to an increase in the interest paid on the debt under certain circumstance). This is without prejudice to the right of the lender to petition for winding up of the borrower in the event of borrower's failure to meet his debt servicing obligations.

6. Repayment: The debt agreement should not provide for a put option exercisable by the lenders. It can, however, provide the bank with the call option for early repayments, which can only be exercised with the QCB's prior written agreement. QCB will only agree where it is satisfied that the bank's capital will remain adequate for at least two years after repayment. Note holders should be made aware of the restrictions on early repayment, either through the loan agreement, or in the offer documents or through other appropriate means.

Prior to agreeing to early repayment the bank should provide the QCB with its capital plan showing that its capital will remain above the minimum prescribed level after repayment, and that it is likely to remain so for at least two years.

- 7. Amortisation:** During the last four years to maturity, a cumulative discount (or amortization) of 20% per year will be applied to reflect the diminishing value of these instruments. Calculation of percentage eligible for inclusion within supplementary capital shall be based on the following:

Remaining Term to Maturity	Percentages
From 4 to less than 5 years	80
From 3 to less than 4 years	60
From 2 to less than 3 years	40
From 1 to less than 2 years	20
Less than 1 year	0

8. Step-ups: There are two methods of treating subordinated debt which includes a step-up, which a bank should adopt:

- Where the sum of all possible step-ups is no more than 50 basis points in the first ten years of the issue or not more than 100 basis points over the whole life of the issue, the debt may be treated as at its original maturity.
- Issues with step-ups of more than 50 basis points in the first ten years of an issue, or more than 100 basis points over the life of an issue should be treated as term debt which matures at the date the step-up is triggered.

The limits on step-ups are cumulative and apply to the all-in cost of debt to the bank. QCB objects to high step-ups as they can make a bank's capital expensive and defeats the very rationale of not calling the issue. Further, subordinated debt to be eligible for inclusion in the capital base, no step-up is to be allowed in the first five years.

Banks should discuss proposed step-ups with the QCB in advance to ensure that the same meet the above criteria. At times, a floating rate debt issue may provide for a change of benchmark interest rate from one standard to another (e.g. from a T-bill rate to a LIBOR rate) in case of failure to exercise the call. The QCB will take into consideration whether any such changes in reference rate constitutes an excessive step-up. Similarly, QCB will like to consider issues containing embedded options, e.g. issues containing options for the interest rate after the step-up to be at a margin over the higher of the two (or more) reference rates, or for the interest rate in the previous period to act as a floor. The inclusion of such options may adversely affect the funding cost of the borrower, and indirectly imply a step-up.

Banks can raise, with the approval of their Boards, subordinated debt as Tier 2 capital, subject to the above terms and conditions provided that total supplementary capital shall not exceed 100% of the Tier 1 capital.