

# **CENTRAL BANK OF NIGERIA**



## **GUIDANCE NOTES ON THE CALCULATION OF CAPITAL REQUIREMENT FOR CREDIT RISK FOR NON-INTEREST FINANCIAL INSTITUTIONS IN NIGERIA**

### **STANDARDIZED APPROACH**

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# Contents

DEFINITION OF TERMS.....	3
1.0 INTRODUCTION .....	6
1.1 Individual Claims Based on External Credit Assessments.....	7
1.2 Off-balance Sheet Exposures .....	9
1.3 Exposures in Investments Made under Profit-Sharing Modes.....	10
1.3.1 Commercial enterprise to undertake a business venture.....	10
(a) Simple risk-weight method .....	11
1.3.2 Supervisory slotting method.....	12
1.3.4 Equity investments in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes .....	12
1.3.5 A Specified Project.....	13
1.3.6 <i>Musharakah</i> with <i>Ijarah</i> or <i>Murabahah</i> sub-contract .....	13
1.3.7 Preferential Risk Weights Based on Underlying Assets .....	14
1.4. Retail Portfolios .....	14
1.5. Residential Real Estate .....	15
1.6. Commercial Real Estate .....	15
1.7 Past Due Receivables.....	16
1.8. Other Assets.....	16
1.9 Higher Risk Weights .....	16
2.0 CREDIT RISK MITIGATION .....	17
2. 1. Credit Risk Mitigation Techniques .....	18
2.2 Types of Collateral .....	20
2.3 Risk Mitigation Approaches.....	21
2.3.2 Comprehensive Approach .....	22
2.4. Maturity Mismatch .....	24
2.5 Credit Risk Mitigation for <i>Mudarabah</i> Exposures .....	24
2.6 Treatment of an Exposure Covered by Multiple CRM Techniques.....	25
2.7 Recognition of Ratings by ECAI .....	25
3.0 COMMODITY <i>MURABAHAH</i> TRANSACTIONS .....	25
3.1 Capital Requirements for CMT .....	26
3.2.1 Credit Risk Weight for Commodity Murabaha Transactions .....	26
4.5 Capital Requirements for <i>Sukuk</i> .....	26
APPENDIX A: SUPERVISORY SLOTTING FOR NIFI's PRODUCTS .....	28
APPENDIX B: SUPERVISORY SLOTTING FOR DIMINISHING MUSHARAKAH .....	35

## DEFINITION OF TERMS

Non-interest Financial Institutions	Means banks and other financial institutions under the regulatory purview of the Central Bank of Nigeria that provide banking and other financial services on the basis of Islamic Commercial Jurisprudence.
Investment Account Holders (IAHs)	These are individuals and institutions that place funds with NIFIs for the purpose of profit sharing under <i>Mudarabah</i> contract. Losses, if any, are borne by the investment account holders.
Diminishing <i>Musharakah</i> (DM)	A form of partnership in which one of the partners (Customer) promises to buy the equity share of the other partner (NIFI) over a period of time until the title to the equity is completely transferred to the buying partner.
<i>Hibah</i> (Gift)	A unilateral transfer of ownership of a property to another without any counter-value from the recipient.
<i>Ijarah</i> (Leasing)	An <i>Ijarah</i> contract refers to an agreement made by NIFIs to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rentals. An <i>Ijarah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijarah</i> contract.
<i>Ijarah wa Iqtina</i> (Finance Lease)	A finance lease contract that provides a separate promise of the lessor giving the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value, or by means of a <i>Hibah</i> contract.
Investment Risk Reserve (IRR)	The amount appropriated by the NIFIs out of the income of Investment Account Holders (IAH), after allocating the <i>Mudarib</i> 's share in order to cushion against future investment losses for IAH.
Islamic Window	An Islamic window is part of a conventional financial institution that mobilises deposits and provides fund management (investment accounts), financing and investment, and other banking services that are Shariah compliant, with proper segregation of funds from the parent unit.
<i>Istisna</i> (Construction)	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
<i>Mubara'at</i> (Mutual Waiver)	An agreement between a NIFI and its customer whereby at the time of early withdrawal, the customer will waive a certain portion of his profits earned during the investment period, and the NIFI will not recall any payment made to him on losses incurred in the investment period.
<i>Mudarabah</i> (Trust Partnership)	A partnership contract between the capital provider ( <i>Rabb al-Mal</i> ) and an entrepreneur ( <i>Mudarib</i> ) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are

	shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
<i>Murabahah</i> (Cost Plus Mark-Up Sale)	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
<i>Murabahah</i> for the purchase orderer (MPO)	A sale contract whereby the institution offering Islamic financial services (NIFI) sells to a customer at cost plus an agreed profit margin (selling price) a specified kind of asset that has been purchased and acquired by the NIFI based on a promise to purchase from the customer, which can be binding or non-binding.
<i>Musharakah</i> (Partnership)	A contract between the NIFI and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or movable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>Musharakah</i> agreement, while losses are shared in proportion to each partner's share of capital.
Profit Equalization Reserve (PER)	The amount appropriated by the institution offering Islamic financial services out of the <i>Mudarabah</i> income, before deducting the <i>Mudarib</i> 's share, in order to maintain a certain level of return on investment for investment account holders and to increase owners' equity.
<i>Qard</i> (Loan)	A loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
Restricted Investment Account (RIA)	An account in which the holder authorizes a NIFI to invest funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
<i>Salam</i> (Forward Sales)	An agreement to purchase, at a pre-determined price, a specified kind of fungible commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institutions offering Islamic financial services as the buyers make full payment of the purchase price upon conclusion of a <i>Salam</i> contract.
<i>Shari'ah</i> (Islamic Law)	The divine laws derived from the Qur'an and Sunnah and other sources such as consensus and analogical deductions from the Qur'an, Sunnah and consensus.
Advisory Committee of Experts (ACE)	An independent body set up by Non-Interest Financial Institutions (NIFIs), as part of their <i>Shari'ah</i> governance system, to supervise and ensure compliance with the <i>Shari'ah</i> .
<i>Sukuk</i>	<i>Sukuk</i> are certificates of equal value representing undivided shares in

(Islamic Investment Certificates)	ownership of tangible assets, usufruct and services, or (in the ownership) of assets of particular projects or special investment activity.
<i>Takaful</i> (Islamic Insurance)	The term " <i>Takaful</i> " is derived from Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a <i>Takaful</i> arrangement, the participants contribute a sum of money as wholly or partially <i>Tabarru</i> (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the <i>Takaful</i> .
Unrestricted Investment Accounts (UIA)	The account holders authorize the NIFI to invest their funds based on <i>Mudarabah</i> or <i>Wakalah</i> contracts without imposing any restrictions. The NIFI can commingle these funds with their own funds and invest them in a pooled portfolio.
<i>Wadi'ah</i>	The term " <i>Wadi'ah</i> " means custody or safe-keeping whereby the items are held in trust by the safe-keeper. The items are not guaranteed by the safe-keeper, except in the case of misconduct, negligence or violation of the conditions.
<i>Wakalah</i> (Agency Contract)	<i>Wakalah</i> is a contract where one party, the principal ( <i>Muwakkil</i> ), appoints the other as agent ( <i>Wakil</i> ) to carry out a business or transaction on his behalf with or without any fee.
Securitization Exposures.	Basel II defines a traditional securitization (in conventional finance) as a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

## 1.0 INTRODUCTION

1. Credit risk exposures in Islamic financing arise from accounts receivable in *Murabahah* contracts, counterparty risk in *Salam* contracts, accounts receivable and counterparty risk in *Istisna* contracts, lease payments receivable in *Ijarah* contracts, Capital investment/counterparty risk in *Wakalah* and *Sukuk*<sup>1</sup> held in the banking book. In this Guidance Notes, credit risk is measured according to the standardized approach of Basel II, as will be discussed below, except for certain exposures arising from investments by means of *Musharakah* or *Mudarabah* contracts included in assets in the banking book. The latter are to be treated as giving rise to capital impairment risk as well as credit risk and are risk-weighted depending on the structure and purpose of the enterprise and the types of assets in which the funds are invested.
2. The assignment of Risk Weights (RW) shall take into consideration the following:
  - (a) The credit risk rating of a debtor, counterparty or other obligor, or a security, based on external credit assessments. NIFIs are to refer to CBN-approved External Credit Assessment Institutions (ECAIs) that are to be used in assigning credit ratings for the purpose of calculating credit RWs;
  - (b) Credit risk mitigation techniques adopted by the NIFI;
  - (c) Types of underlying assets that are sold, collateralized or leased by the NIFI; and
  - (d) Amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.
3. A NIFI shall disclose the names of the ECAIs that it has used for the purpose of assigning RWs to its assets. If there are two assessments by ECAIs chosen by a NIFI which map into different risk weights, the higher RW will be applied. To illustrate, if there are two external credit assessments mapping into credit grades with risk weights of 20% and 50% then the applicable risk weight is 50%. If there are three or more assessments with different risk weights, the assessments corresponding to the two lowest RWs should be referred to and the higher of those two RWs will be applied. For example, if there are three external credit assessments mapping into credit grades with risk weights of 0%, 20% and 50%, and then the applicable risk weight is 20%.

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<sup>1</sup>This is an additional item to IFSB-15 in the list of credit risk exposures of Islamic banks. It was added based on Examiners' review of local Islamic banks' operations.

## 1.1 Individual Claims Based on External Credit Assessments

4. Exposures to the following counter parties are credit risk weighted in accordance with the table below:

Table 1: Risk Weights and Ratings for Exposures to Governments Agencies

<b>Risk Weights Rating/Risk Score</b>	<b>AAA to AA-</b>	<b>A+ to A-</b>	<b>BBB+ to BBB-</b>	<b>BB+ to B-</b>	<b>Below B-</b>	<b>Unrated</b>
<b>ECA Country Risk Score</b>	1	2	3	4 to 6	7	
<b>Counterparty</b>	<b>Risk Weight (RW)</b>					
Sovereigns and central banks (a)	0%	20%	50%	100%	150%	100%
Non-central government public sector entities (PSEs)(c)	Subject to CBN regulations from time to time					

Table 2: Risk Weights and Ratings for Exposures to Other Agencies

<b>Rating/Risk Score</b>	<b>AAA to AA-</b>	<b>A+ to A-</b>	<b>BBB+ to BBB-</b>	<b>BB+ to B-</b>	<b>Below B-</b>	<b>Unrated</b>
<b>ECA Country Risk Score</b>	1	2	3	4 to 6	7	
Multilateral development banks (MDBs)(d)	20%	50%	50%	100%	150%	50%
NIFI, banks and securities firms Option 1*	20%	50%	100%	100%	150%	100%
Option 2a**	20%	50%	50%	100%	150%	50%
Option 2b** @ (e)	20%	20%	20%	50%	150%	20%
<b>Rating/Risk Score</b>	<b>AAA to AA-</b>	<b>A+ to A-</b>	<b>BBB+ to BB-</b>	<b>Below BB-</b>		<b>Unrated</b>
Corporate	20%	50%	100%	150%		100%

\*Credit assessment based on ECAI of sovereigns.

\*\*Credit assessment based on an ECAI of the NIFIs and securities firms.

@ Applicable for original maturity  $\leq$  3 months which is not rolled over.

5. Notwithstanding the ratings by the ECAIs, the following exceptions can apply:

(a)The Central Bank of Nigeria (CBN) has the discretion to reduce the RW for exposures to the sovereigns and central banks that are denominated and funded in domestic currency. This lower RW may be extended to the risk-weighting of collateral and guarantees. The CBN may extend this treatment to portions of claims guaranteed by the sovereigns or central banks,

provided the guarantee is denominated in the domestic currency and the exposure is funded in that currency.

(b) Inclusive of international organizations/official entities that will receive a 0% RW as determined by the CBN.

(c) Exposure to Public Sector Entities (PSEs) such as Ministries, Departments and Agencies (MDAs) owned by the Federal Government shall be assigned a risk weight of 100% regardless of the length of the residual maturities of the exposure. Public sector entities include both commercial and non-commercial entities owned by Federal, State and Local Government. The exposure of on a foreign PSE shall be risk weighted according to the credit rating applicable to the jurisdiction where the PSE is located.

(d) Exposure to State and Local Governments in Nigeria shall receive the following risk weights:

- i. 20% risk weight for State Government *Sukuk and* exposures that meets the eligibility criteria for classification as liquid assets by the CBN as per the Guidelines for Granting Liquid Assets Status to *Sukuk* Instrument issued by state governments.
- ii. 50% risk weights for other State Governments *Sukuk* and exposures that do not meets the eligibility criteria for classification as liquid assets by the CBN.
- iii. 100% risk weight for other Local Government *Sukuk* and exposures.

(d) The following Multilateral Development Banks are eligible for a 0% Risk Weight;

- 1) International Bank for Reconstruction and Development (IBRD);
- 2) International Finance Corporation (IFC);
- 3) African Development Bank (AfDB);
- 4) Asian Development Bank (ADB)
- 5) European Bank for Reconstruction and Development (EBRD)
- 6) Inter-American Development Bank (IADB)
- 7) European Investment Bank (EIB)
- 8) European Investment Fund (EIF)
- 9) Nordic Investment Bank (NIB)
- 10) Caribbean Development Bank (CDB)
- 11) Islamic Development Bank (IDB)
- 12) Council of Europe Development Bank (CEDB)
- 13) International Islamic Liquidity Management Corporation (IILMC)
- 14) Any other MDBs that may be specified from time to time by the CBN.

(e) Under Option 2b, the RWs are one category less favorable than that assigned to claims on the sovereigns subject to a floor of 20% when the exposure is denominated and funded in domestic currency.

(f) An unrated corporate shall not be given a preferential RW compared to its sovereign. The CBN has the discretion to require a RW higher than 100%, or to allow all corporates to be risk-weighted at 100%.



6. For any claim with an original maturity of up to three months that is not rolled over, the short-term RW as set out in the table below shall be applied.

Table 3: Risk Weights and Ratings for Exposures base on maturity

Rating/Risk Score	A-1 / P-1	A-2 / P-2	A-3 / P-3 or unrated	Others
Risk weight	20%	50%	100%	150%

7. The CBN has the discretion to allow a NIFI to apply an internal-rating based approach if it meets the minimum requirements set by CBN.

## 1.2 Off-balance Sheet Exposures

8. Off-balance-sheet items under the standardized approach will be converted into credit exposure equivalents through the use of Credit Conversion Factors (CCF).
9. Commitments with an original maturity up to one year and those 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 NIFI without prior notice, or that effectively provide for automatic cancellation due to deterioration in the credit worthiness of the obligor will receive a 0% CCF.
10. An import or export financing which is based on *Murabahah* where the underlying shipment are collateralized and insured shall attract a 20% CCF to the NIFI that issues or confirms the Letter of Credit (LC). This treatment of collateral assumes there are no obstacles to the exercise of rights over it by the issuer or confirmer.
11. *Shari'ah*-compliant alternatives to repurchase agreements and securitized financing will receive a CCF of 100%. Furthermore, a CCF of 50% will be applied to certain transaction-related contingent items such as performance bonds, bid bonds and warranties. Direct credit substitutes, such as standby letters of credit serving as financial guarantees against financing and securities, or irrevocable credit commitments, will receive a CCF of 100%.
12. *Shari'ah*-compliant hedging contracts that are traded over-the-counter (OTC) expose a NIFI to counterparty credit risk (CCR). CCR refers to the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. An economic loss would occur if the transaction or portfolio of transactions with the counterparty had a positive economic value at the time of default. Unlike a firm's exposure to credit risk through a financing arrangement where the exposure to credit risk is unilateral and only the NIFI financing the transaction faces the risk of loss, CCR involves a bilateral risk of loss that is, the market value of the transaction can be positive or negative to either counterparty to the transaction, depending on the movements in the market prices of the underlying variables.

13. A credit equivalent for *Shari'ah*-compliant hedging techniques can be derived using the Current Exposure Method. The credit equivalent exposure is based on the positive mark-to-market replacement cost of the contract. An add-on factor will be added to cover for potential future credit exposure.

### **1.3 Exposures in Investments Made under Profit-Sharing Modes**

14. A NIFI shall provide financing and hold investments made under profit and loss sharing mode (*Musharakah*) or profit-sharing and loss-bearing mode (*Mudarabah*) which may be used, *inter alia*, to invest in the following:

- (a) Commercial enterprise to undertake a business venture (with the intention of holding the investment for an indefinite period or with a view to eventual sale, such as venture capital investments or privately held equity);
- (b) Diminishing *Musharakah* in which the share of the NIFI can be gradually reduced during the tenure of the contract until the asset is fully sold to the partner(s);
- (c) Equity investment in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes;
- (d) Specific project; or
- (e) Joint ownership of real assets or movable assets (such as cars) on a *Musharakah* basis for onward lease or sale on an *Ijarah* or a *Murabahah* basis, respectively (i.e. *Musharakah* with an *Ijarah* or *Murabahah* sub-contract).

15. This section also covers such exposures of the NIFI that are not held for trading but for the purpose of earning investment returns from medium- to long-term financing (i.e. held in the "banking book"). Such investments are:

- (a) Not held with the intent of trading or short-term resale benefiting from actual or expected price movements.
- (b) Not marked-to-market on a daily basis;
- (c) Not actively monitored with reference to market sources; and
- (d) Exposed to credit risk in the form of capital impairment risk

16. In assigning the RW, consideration shall be given to the intent of the profit-sharing investment, and to the nature of the underlying assets. For the purpose of determining minimum capital requirements, the RW shall be applied based on sections 1.3.1 to 1.3.6 below.

#### **1.3.1 Commercial enterprise to undertake a business venture**

17. Financing on a *Musharakah* or *Mudarabah* basis of a commercial enterprise to undertake a business venture can expose a NIFI to capital impairment risk as well as credit risk, to an extent that depends on the structure and purpose of the financing and the types of assets in which the funds are invested. Commonly, a NIFI would invest in a commercial

enterprise with the intention of holding the investment for an indefinite period or with a view to eventual sale (as in the case of venture capital or private equity investments). As an equity investor, the NIFI's rights and entitlements are subordinated to the claims of secured and unsecured creditors. Capital impairment risk is the risk of losing the amount invested in an enterprise or in the ownership of an asset. Such impairments may arise for two kinds of reasons:

(a) The investee may be unprofitable, so that the investor NIFI fails to recover its investment; and

(b) The *Musharakah* partner or *Mudarib* may fail either to:

(i) pay the NIFI's share in the profit on a periodical basis, as contractually agreed; or

(ii) settle the NIFI's entitlement to its share of the capital and the profits at the time of redemption.

18. The former reason is an impairment of capital without any credit default being involved; whereas the latter, being a failure of the partner to meet its contractual obligations, is a type of credit default.

19. The RW for such investments (*Mudarabah* and *Musharakah*) shall be calculated according to either of the following methods:

(a) Simple risk-weight method, treating the investment as an equity exposure held in the banking book;

(b) Supervisory slotting method, considering the investment as a type of specialized financing.

**(a) Simple risk-weight method**

20. For *Musharakah* or *Mudarabah* investments in commercial enterprises whose common shares are listed on a recognized security exchange, a 300% RW is to be applied. For *Musharakah* or *Mudarabah* investments in all other enterprises, a 400% RW will be applicable.

21. From a risk management perspective, a major distinction between *Mudarabah* and *Musharakah* financings relates to the NIFI's involvement in the investments during the contract period. In *Mudarabah*, the NIFI invests as a silent partner and the management is the exclusive responsibility of the other party, namely the *Mudarib*. In contrast, in *Musharakah* financing, the NIFI (and its partner or partners) invest their funds together, and the NIFI may be a silent partner, or may participate in management. Therefore, the CBN may at its discretion allow the application of a 300% RW for any such *Musharakah* financing. Furthermore, in all cases where the NIFI can withdraw its financing at short notice (maximum five working days), the investment may be considered as being as liquid as publicly traded equity holdings. The applicable RW in such a case will be 300%.

22. In other types of financing, a NIFI can use eligible *Shari'ah*-compliant risk mitigation techniques in profit-sharing financing to reduce the credit exposure and risk of possible capital impairment. The use of such risk mitigation and subsequent reduction in credit exposure shall be taken into account when calculating the capital requirements of the NIFI.

### 1.3.2 Supervisory slotting method

23. In appropriate cases related mostly to project finance or business ventures, the CBN may permit a NIFI to employ an alternative approach, namely the supervisory slotting criteria. Under this method, a NIFI may be required to map its internal risk grades into four supervisory categories for specialized financing, as set out in Appendix A. Each of these categories will be associated with a specific RW, as given in the following. These RWs include an additional fixed factor of 20% RW to cater for the potential decline in the *Mudarabah*'s or *Musharakah*'s net asset value.

Table 4: Supervisory Slotting Method Risk Weights

Supervisory Categories	Strong	Good	Satisfactory	Weak
Risk weights	90%	110%	135%	270%

### 1.3.3 Diminishing Musharakah

24. If a Diminishing *Musharakah* contract is related to a specific fixed asset/real estate leased to a customer under an *Ijarah* contract, the NIFI's credit exposure will be similar to an exposure under a *Musharakah* with an *Ijarah* sub-contract. In this case, the *Musharakah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by an ECAI and 100% RW on residual value of an asset. In case the counterparty is unrated, a RW of 100% shall apply.
25. However, if the exposure under the Diminishing *Musharakah* contract consists of working capital finance in the customer's business venture, the NIFI shall measure its credit risk similarly to an equity exposure held in the banking book. This treatment will be, however, subject to the consideration of any third-party guarantee to make good impairment losses. In that case, the RW of the guarantor shall be substituted for that of the outstanding balance of the *Musharakah* investment for the amount of any such guarantee. Moreover, subject to CBN approval, a NIFI can use the supervisory slotting method, based on the criteria set out in Appendix B.

### 1.3.4 Equity investments in a company or an Islamic collective investment scheme not held for short-term resale or trading purposes

26. Such a holding is not a trading book exposure, and thus the "look-through" principle, whereby the RW of the exposure would be that of the underlying assets does not apply and the exposure is that of an equity position in the banking book. Banking book investments would not normally include investments in common shares or Islamic collective investment schemes that are publicly listed.

27. However, if such an investment is in an entity or Islamic collective investment scheme (consisting predominantly of equity instruments/stocks) that is publicly listed on a recognized securities exchange, the holding being not for short-term resale or trading purposes, a 300% RW shall be applied, consistent with the simple RW method. Likewise, a 400% RW shall be applied to all other equity holdings. The exposure in such investments shall be measured at the carrying values of the investments, according to the International Financial Reporting Standards (IFRS).

### **1.3.5 A Specified Project**

28. A NIFI can advance funds to a construction company which acts as *Mudarib* in a construction contract for a third-party customer (ultimate customer). The ultimate customer will make progress payments to the *Mudarib*, who in turn makes payments to the NIFI. The essential role of the NIFI in this structure is to provide bridging finance to the *Mudarib* pending its receipt of the progress payments. In this *Mudarabah* structure, the NIFI as investor advances funds as *Rabb-al-Mal* to the construction company as *Mudarib* for the construction project, and is thus entitled to a share of the profit of the project but must bear 100% of any loss (except in cases of negligence or misconduct). In most cases, the NIFI has no direct or contractual relationship with the ultimate customer, but in such a structure the NIFI stipulates that payments by the ultimate customer to the *Mudarib* be made to an account ("repayment account") with the NIFI which has been opened for the purpose of the *Mudarabah* and from which the *Mudarib* may not make withdrawals without the NIFI's permission.
29. In such a case, the NIFI is exposed to the risk on the amounts advanced to the *Mudarib* under the *Mudarabah* contract, but this risk would be mitigated by the amounts received from the ultimate customer into the "repayment account" which are effectively collateralized. Thus, while under the *Mudarabah* contract the amounts advanced by the NIFI to the *Mudarib* would normally be treated under credit risk as "equity positions in the banking book", the use of the structure involving a "repayment account", whereby the ultimate customer makes payments into such an account with the NIFI instead of making payments directly to the *Mudarib*, has the effect of substituting the credit risk of the ultimate customer for that of the *Mudarib* to the extent of the collateralized balance of the "repayment account".
30. In addition to credit risk (i.e. in the absence of a repayment account, the risk that the *Mudarib* has received payment from the ultimate customer but fails to pay the NIFI, or, if the repayment account is used, that the ultimate customer fails to pay), the NIFI is exposed to capital impairment in the event that the project results in a loss. The proposed RW and impact of credit risk mitigation are explained in section 1.3.6

### **1.3.6 Musharakah with Ijarah or Murabahah sub-contract**

31. A NIFI can establish joint ownership of tangible fixed assets (such as cars, machinery, etc.) with a customer on a *Musharakah* basis, the assets being leased or sold on an *Ijarah*

or a *Murabahah* basis, respectively. In these cases, the "look-through" principle (whereby the RW is that of the underlying contract) applies, as explained below:

a) In the case of *Ijarah*, ownership of such assets can produce rental income for the partnership, through leasing the assets to third parties by means of *Ijarah* contracts. In this case, the risk of the *Musharakah* investment is that of the underlying *Ijarah* contracts – that is, credit risk mitigated by the "quasi-collateral" represented by the leased assets. In the event the asset is leased to the NIFI's partner as a customer instead of to a third party, the credit risk will relate to the partner's obligation to pay the lease rentals. This *Musharakah* investment shall be assigned a RW based on the credit standing of the counterparty/lessee, as rated by CBN-approved ECAI, and a 100% RW on the residual value of the *Ijarah* asset. In the event the counterparty is unrated, a RW of 100% shall apply.

b) In the case of *Murabahah*, the NIFI is entitled to its share of income (mark-up) generated from selling the assets to third parties. The NIFI as a capital contributor is exposed to credit risk in respect of the *Murabahah* receivables from the buyer/counterparty. This *Murabahah* investment shall be assigned a RW based on the credit standing of the counterparty/buyer, as rated by CBN-approved ECAI. In the event the counterparty is unrated, a RW of 100% shall apply.

### **1.3.7 Preferential Risk Weights Based on Underlying Assets**

32. The RW of a debtor, counterparty or other obligor shall be reduced and given preferential treatment if the underlying assets are financed under *Murabahah*, *Ijarah (Operating Lease)*, *Ijarah Wa Iqtinah (Finance Lease)*, *Istisna* or Diminishing *Musharakah*.

### **1.4. Retail Portfolios**

33. The RW to exposures of a NIFI to retail portfolio shall be 75% if the exposures meet the following conditions:

- (a) The financing is provided to an individual person or persons or a small business;
- (b) The subject matter of the financing is pledged as collateral to the NIFI;
- (c) The aggregate receivables (accounts receivable in *Murabahah* and *Istisna*, lease payments receivable in *Ijarah Wa Iqtinah*, and share purchase plus lease receivables in Diminishing *Musharakah*) due from a single counterparty or person(s) shall not exceed ₦100 Million subject to CBN guideline from time to time; and
- (d) The regulatory retail portfolio is adequately diversified so that this reduces the risks in the portfolio. Aggregate exposure (without taking any credit risk mitigation into account) to one counterpart cannot exceed 1% of the overall regulatory retail portfolio. CBN may at its discretion specify the numerical limit from time to time.

34. Any retail financing contract which is collateralized (or quasi-collateralized) by an asset other than the subject matter of the financing will not qualify for this preferential

treatment unless the value of such collateral after adjustment for haircuts is higher than the aggregate selling price of the financed asset throughout the tenure of the contract.

35. For any financing on the basis of the aforementioned contracts that is fully secured by real estate, the accounts or lease payments receivable can be excluded from this category and qualify for a lower RW as stated with respect to residential real estate (RRE) in section 1.5.

### **1.5. Residential Real Estate**

36. A NIFI shall apply RW of 75% if the property is located in Nigeria subject to meeting the prudential criteria imposed by the CBN, which include, *inter alia*:

- (a) The real estate is to be utilized for residential purposes only;
- (b) The subject matter of RRE must be pledged as collateral (or serve as quasi-collateral) to the NIFI in the case of *Murabahah*, *Ijarah Wa Iqtinah* or Diminishing *Musharakah*;
- (c) The total accounts/lease receivables do not exceed 50% of the market value of the collateralized RRE subject to professional valuation of the RRE made within one year preceding the contract date, the 50% figure being subject to the CBN's discretion; and
- (d) There exists a legal infrastructure whereby the NIFI can enforce the repossession and liquidation of the RRE.

The CBN has discretion to apply a higher RW if any of the above criteria are not met.

### **1.6. Commercial Real Estate**

37. NIFIs shall apply a RW of 100% for Commercial Real Estate (CRE) located in Nigeria. However, subject to the CBN's discretion, a preferential RW of 50% can be applied provided that, *inter alia*:

- (a) a well-developed and long-established CRE market is readily available;
- (b) financing is provided for office and/or multi-purpose premises and/or multi-tenanted premises;
- (c) the CRE is collateralized (or quasi-collateralised) in case financing is provided on the basis of *Murabahah*, *Ijarah Wa Iqtinah* or diminishing *Musharakah*;
- (d) the tranche or outstanding balance of the financing does not exceed 50% of the market value of the collateralized CRE; and
- (e) total losses from CRE financing do not exceed 0.5% of the total amount due in respect of the outstanding balance of the financing in any given year.

## 1.7 Past Due Receivables

38. In the event that accounts receivable or lease payments receivable become past due, the exposure shall be risk-weighted in accordance with the following table. The exposures should be risk-weighted net of specific provisions.

Table 5: Risk Weights for Past Due Exposures

Type	Risk Weighted	% of Specific Provisions for Past Due Receivables
Unsecured exposure (other than unsecured portion of receivable partly secured by RRE) that is past due more than 90 days, net of specific provisions.	150%	Less than 20% of the outstanding receivables.
	100%	At least 20% of the outstanding receivables.
	100%	At least 50% of the outstanding receivables, but the CBN have discretion to reduce RW to 50%.
Exposure fully secured by other than eligible collateral.	100%	At least 15% of the outstanding receivables. The CBN is to set strict operational criteria to ensure the quality of collateral.
Exposure secured by RRE	100%	For receivables that are past due for more than 90 days, net of specific provisions.
	50%	The RW can be reduced to 50% RW if specific provisions are at least 20% of the outstanding receivables at CBN discretion.

## 1.8. Other Assets

39. Other assets shall be risk-weighted at 100%. A RW of 20% shall be applicable on cash items under collection. Investments in regulatory capital instruments issued by banks or securities firms will have a RW of 100%, provided they are not deducted from the capital of the NIFI.

## 1.9 Higher Risk Weights

40. The following exposures are regarded as high risk exposures and are assigned specific risk weights as follows:

- Investments in venture capital firms will be risk weighted 150%;
- Investment in equity financial instruments that are non-publicly traded (inclusive of investments/financing structured based on Musharakah and Mudarabah contracts) shall be risk-weighted at 150%



- c) Investment in non-financial firms with negative financial results over the past two years will be risk-weighted at 200%.
- d) Where exposure to a particular industry within a sector (as defined by the International Standard Industrial Classification of Economic Sectors as adopted by CBN) is in excess of 20% of total credit facilities of the bank, the risk weights of the entire exposures to that industry will be 150%. If, for instance, the total exposure of a bank to food manufacturing industry within the manufacturing sector is in excess of 20% of the total credit facilities, the entire exposure to food manufacturing industry will be risk weighted at 150%.

## **2.0 CREDIT RISK MITIGATION**

- 41. The exposure in respect of a debtor, counterparty or other obligor can be further adjusted or reduced by taking into account the Credit Risk Mitigation (CRM) techniques employed by the NIFIs. This section covers CRM used by NIFIs in the Standardized Approach and outlines criteria, methodologies and specific requirements for using these techniques.
- 42. The use of only one CRM technique on an exposure is permitted. However, double counting of CRM impacts shall not be permitted. Therefore, additional supervisory recognition of CRM will not be allowed on receivables for which an issue-specific rating is used that already reflects that CRM. NIFIs should also take into account any residual risks arising out of use of CRM techniques such as market, operational, legal and liquidity risks. Therefore, a NIFI should have a strategy, policies and procedures to control and manage residual risks. Further, the impact of these risks on the overall credit profile and concentration risk of the NIFI should be monitored and controlled.
- 43. The collateral used as a part of CRM must be compliant with *Shari'ah* requirements. The collateralization shall be properly documented in a security agreement or in the body of a contract to the extent permissible by *Shari'ah*, and must be binding on all parties and legally enforceable and should carry out periodic reviews to confirm its enforceability at all times. The NIFI cannot recognize a commitment to provide collateral or a guarantee as an eligible CRM unless such a commitment is actually executed.
- 44. There shall be a negligible positive correlation, if any, between the value of collateral and the credit quality of counterparty. Consequently, securities issued by a counterparty or its related entities would not be eligible for collateral.
- 45. For a collateralized transaction – such as *Shari'ah*-compliant alternatives to repo/reverse repo or financing of Sukuk and Islamic securities – capital requirements shall be applicable on either side of the transaction.

46. CBN can impose additional capital charges or take other supervisory steps under Guidance Note on Supervisory Review Process issued by CBN if residual risks are not effectively controlled.

47. The requirements for relevant disclosure of CRM techniques by NIFI are specified under Guidance Note on Disclosure Requirements for NIFIs issued by the CBN.

## **2. 1. Credit Risk Mitigation Techniques**

48. The CRM techniques that will be commonly employed by NIFIs shall be as follows:

**(a) *Hamish Jidiyyah* (earnest deposit)**

49. *Hamish Jidiyyah* (HJ): An earnest deposit taken by a NIFI prior to entering into a contract carries a limited recourse to the extent of damage incurred by the NIFI when the customer fails to honour a binding Promise to Purchase (PP) or Promise to Lease (PL)

**(b) *Urbun* (earnest money held after a contract is established to guarantee contract performance)**

50. The *Urbun* taken from a purchaser or lessee when a contract is established accrues to the benefit of the NIFI if the purchaser or lessee fails to execute the contract within the agreed term which qualifies it as an eligible CRMT.

**(c) *Kafalah* (Guarantee from a third party i.e. recourse or non-recourse guarantee)**

51. The guarantor may or may not have recourse to the obligor (i.e. purchaser or lessee) and the guarantee can be for a fixed period and for a limited amount, without any consideration being received by the guarantor. However, a claim should first be made against the obligor, and then against the guarantor, unless an option is provided to make the claim against either the obligor or the guarantor.

52. The guarantee can also be given in a "blanket" form that covers an unknown amount or a future receivable. However, this type of guarantee (sometimes known as a "market/business guarantee" or "guarantee of contractual obligation") is revocable at any time prior to the existence of the future receivable and does not qualify as an eligible CRM.

53. The CBN may give capital relief for the use of a guarantee that meets the following conditions:

(i) The guarantee represents the NIFI's direct claim on the guarantor;

(ii) The guarantee is irrevocable and does not allow the guarantor to cancel unilaterally the guarantee after the creation of the receivables;

(iii) The guarantee is unconditional and provides no protection clause that prevents the guarantor from being obliged to pay out in a timely manner in the event that the original counterparty fails to make payments due;

(iv) The NIFI has the right to pursue, in a timely manner, the guarantor for monies outstanding, rather than having to pursue the original counterparty to recover its exposure;

(v) The guarantee shall be an explicitly documented obligation assumed by the guarantor; and

(vi) The guarantee shall cover all types of expected payments made under the contract in the event that the original counterparty defaults.

54. It is permitted to have a range of guarantors to cover the exposure. Guarantees issued by parties with a lower RW than the counterparty will result in a reduction of the capital charge because the credit exposure covered by the guarantee is assigned the RW of guarantor. The RW applicable to the uncovered portion will remain that of the underlying counterparty.

**(d) Pledge of assets as collateral**

55. The pledged asset must be a *Shari'ah*-compliant asset of monetary value that can be lawfully owned, and is saleable, specifiable, deliverable and free of encumbrance. The pledge must be legally enforceable. The asset pledged may either be the underlying asset or any other asset owned by the customer. The pledge of an asset owned by a third party is subject to the owner's consent to the pledge.

56. The pledger can authorize the NIFI, as the pledgee, to sell the asset and to offset the amount due against the sales proceeds without recourse to the courts. Alternatively, the NIFI can demand the sale of the pledged asset in order to recover the amount due. Any surplus from the sale proceeds is to be returned to the pledger, and any shortfall shall be treated as an unsecured exposure that ranks *pari passu* with other unsecured creditors when the debtor is declared insolvent.

57. In case a NIFI takes collateral of an asset pledged more than once, the collateral of the NIFI shall be ranked either *pari passu* to the collaterals of other earlier pledgees with their consent, or junior to the earlier pledgees, in which case the NIFI's claim shall be limited to the residual value of the pledged asset after payment is made to earlier pledgees. The NIFI shall take the residual value after deducting a haircut under the simple approach or the comprehensive approach (the standard supervisory haircuts or the internal haircuts) to offset its credit exposure but should first ascertain the recoverable value of the asset after taking into consideration the NIFI's position as a pledgee as to whether it ranks *pari passu* with the other pledgee(s) or ranks junior to a pledgee that is registered earlier than the NIFI.

**(e) Leased Assets**

58. Assets leased under *Ijarah* or *Ijarah Wa Iqtinah* contracts fulfil a function similar to that of collateral, in that they may be repossessed by the lessor in the event of default by the lessee (hence the term "quasi-collateral" used in this Guideline).

**(f) On-balance sheet netting**

59. Subject to *Shari'ah* approval, netting arrangements between financing assets and deposits/PSIA should be legally enforceable in order to be used as an eligible CRM technique. The net exposure will be used for capital adequacy purposes if the NIFI has a legally enforceable arrangement for netting or offsetting the financing assets and the deposits/PSIA, irrespective of whether the counterparty is insolvent or bankrupt. The NIFI should have a robust system of monitoring those financing assets and deposits/PSIA with the counterparty that is subject to the netting arrangements. In using the net exposure for the calculation of capital adequacy, financing assets shall be treated as exposures and deposits/PSIA as collateral in the comprehensive approach (as per the formula provided in paragraph 67). A zero haircut will be applicable, except in the case of a currency mismatch.

## **2.2 Types of Collateral**

60. The following types of collateral are eligible for relief in respect of the above CRM techniques:

(a) *Hamish Jidiyyah* (security deposit) - only for agreements to purchase or lease preceded by a binding promise.

(b) *Urbun*.

(c) Unrestricted PSIA or cash on deposit with the NIFI which is incurring the exposure.

(d) *Sukuk* rated by an external rating agency, which is issued by:

(i) Sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or

(ii) Issuers other than the above, with a minimum rating of BBB- (for long-term) or A-3/P-3 (for short-term).

(e) *Sukuk* that are unrated by an ECAI but fulfil each of the following criteria:

(i) Issued by a NIFI or a conventional bank (with Islamic windows or subsidiary operations) or a sovereign;

(ii) Listed on a recognized exchange;

(iii) The NIFI which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3;

(iv) The CBN is sufficiently confident about the market liquidity of the securities;

(v) All rated issues by the issuing NIFI must be rated at least BBB- or A-3/P-3 by a recognized ECAI.

(f) *Shari'ah*-compliant equities and units in Islamic collective investment schemes.

(g) Guarantees issued by third parties that fall within the following categories:

(i) Sovereigns and central banks;

(ii) PSEs;

(iii) MDBs;

(iv) International organizations/official entities with a 0% RW;

(v) NIFI or conventional banks (with Islamic windows or subsidiary operations); and

(vi) Corporate entities (including *Takaful*- and *Shari'ah*-compliant securities firms) of a minimum rating of A-. This category includes guarantees issued by parent, subsidiary and affiliate companies when their RW is lower than the ultimate obligor.

(h) Assets pledged as collateral

61. Any portion of the exposure which is not collateralized shall be assigned the RW of the counterparty.

## **2.3 Risk Mitigation Approaches**

62. Capital relief against the collateral can be granted based on either the simple or the comprehensive approach as described below. However, NIFIs are permitted to use either, but not both, of the approaches in reducing their risk exposures in the banking book. NIFIs can use partial collateralization in both approaches. Maturity mismatches between exposure and collateral will only be allowed under the comprehensive approach.

### **2.3.1 Simple Approach**

63. NIFIs can substitute the RW of the collateral for the RW of the counterparty for the collateralized portion of the exposure, subject to the collateral being pledged for at least the duration of the contract. The RW of that collateralized portion shall not be lower than 20%. The uncollateralized portion of the exposure will be assigned the RW of the counterparty. A 0% RW can be applied where the exposure and the collateral are denominated in the same currency, and the collateral consists of any of the following:

(a) Cash or cash equivalents;

(b) A deposit with the NIFI; or

- (c) Sovereign/PSE securities eligible for a 0% RW and its market value has been discounted by 20%.
64. *Shari'ah*-compliant hedging instruments which are normally traded OTC can be given a RW of 0% provided the conditions set out in the following are met:
- (a) The OTC *Shari'ah*-compliant hedging instruments are subject to daily mark-to-market.
  - (b) There is no currency mismatch.
  - (c) The collateral is cash. In case the collateral is not cash, but consists of *Sukuk* issued by sovereigns/PSE that qualify for a 0% RW in the standardized approach, a minimum RW of 10% shall be applicable.
65. In case the above conditions are not fulfilled, see the Current Exposure Method for calculating the credit equivalent.

### 2.3.2 Comprehensive Approach

66. In the comprehensive approach, the exposure to a counter party shall be adjusted based on the collateral used. The NIFI shall adjust *both* the amount of the exposure to the counterparty *and* the value of the collateral, using *haircuts* in order to reflect variations in the value of both the exposure and the collateral due to market movements. The resultant volatility-adjusted amount of exposure and collateral will be used for the calculation of capital requirements for the underlying risk exposure. In most cases, the adjusted exposure will be higher than the unadjusted exposure and adjusted collateral will be lower than the unadjusted collateral, unless either of them is cash. An additional downward adjustment for collateral shall be made if the underlying currencies of exposure and collateral are not similar, so as to take account of foreign exchange fluctuations in the future.
67. Risk-weighted assets shall be calculated by computing the difference between the volatility-adjusted exposure and the volatility-adjusted collateral and multiplying this adjusted exposure by the RW of the counterparty. The formula for calculation of the adjusted exposure after incorporating risk mitigation using the comprehensive approach will be as follows:

$$E^* = \max [0, \{E \times (1 + H_e) - C \times (1 - H_c - H_{fx})\}],$$

Where:

$E^*$  = Adjusted exposure amount after risk mitigation

$E$  = Exposure amount

$H_e$  = Applicable haircut for exposure

$C$  = The current value of underlying collateral

$H_c$  = Applicable haircut for collateral

Hfx = Applicable haircut for foreign exchange exposure, in case exposure and collateral have dissimilar currencies

68. If more than one asset is involved in a collateralized transaction, the haircut on the basket (H) will be a weighted sum of applicable haircuts to each asset ( $H_i$ ), with asset weights ( $a_i$ ) measured by units of currency – that is,  $H = \sum a_i H_i$ .
69. For calculating haircuts, either of the two following methods may be used by NIFI: (a) standard supervisory haircuts; and (b) internal haircuts. The parameters for standard supervisory haircuts and features of qualitative and quantitative criteria for using internal haircuts are provided in the following paragraph.

**(a) Standard Supervisory Haircuts**

70. Both the amount of exposure to counterparty and the value of collateral received are adjusted by using standard supervisory haircuts, as set out below:

Table 6: Standard Supervisory Haircuts

Types of Collateral*	Residual Maturity (yrs)	Haircuts	
		Sovereigns	Others
Cash	All	0	0
<i>Sukuk</i>			
Long-term: AAA to	$\leq 1$	0.5	1
AA- and	$>1$ to $\leq 5$	2	4
Short-term: A-1	$>5$	4	8
<i>Sukuk</i>			
Long-term: A+ to BBB-	$\leq 1$	1	2
and			
Short-term: A-2 to A-3	$>1$ to $\leq 5$	3	6
	$>5$	6	12
<i>Sukuk</i>	All	15	25
Long-term: BB+ to BB-			
<i>Sukuk</i> (unrated)	All	25	25
Equities (listed and included in main index)	All	15	15
Equities (listed but not included in main index)	All	25	25
Units in Islamic collective investment schemes	All	Depending on the underlying assets as above	Depending on the underlying assets as above
Physical assets pledged in accordance with section 3.1.7(d)	All	$\geq 30$	$\geq 30$

*\*Collateral denominated in a different currency will also be subject to an additional 8% haircut to cater for foreign exchange risk.*

**(b) Internal Haircuts**

71. Subject to obtaining approval from CBN, a NIFI may use its own estimate of haircuts to measure market price and foreign exchange volatilities. Such approval will normally require the fulfillment of certain qualitative and quantitative criteria set by the CBN, *inter alia*:

- (i) Integration of risk measures into daily risk management;
- (ii) Validation of any significant change in the risk management process;
- (iii) Verification of consistency, timeliness and reliability of data; and
- (iv) Accuracy and appropriateness of volatility assumptions.

**2.4. Maturity Mismatch**

72. A maturity mismatch is a situation where the residual maturity of the CRM is less than that of the underlying credit exposure. In the case of a maturity mismatch with the CRM having a maturity of less than one year, the CRM will not be recognized. This means that a CRM with a maturity mismatch will only be permitted where its maturity is at least one year. Only the comprehensive approach shall be used for CRM with maturity mismatches. In addition, a CRM having a residual maturity of three months or less, with a maturity mismatch, will not be recognized for capital adequacy purposes.

73. The following adjustment will be applied for a CRM with a maturity mismatch:

$$Pa = P \times (t - 0.25) / (T - 0.25)$$

Where:

Pa = adjusted value of risk mitigation

P = value of risk mitigation used (e.g. collateral or guarantee amount)

T = min (5, residual maturity of the exposure) in years

t = min (T, residual maturity of the risk mitigation) in years

**2.5 Credit Risk Mitigation for *Mudarabah* Exposures**

74. A placement of funds made under a *Mudarabah* contract may be subject to a *Shari'ah*-compliant guarantee from a third party.

75. In such cases, the capital with profit, if any, should be treated with a risk-weighting equal to that of the guarantor provided that the RW of that guarantor is lower than the RW of the *Mudarib* as counterparty. Otherwise, the RW of the *Mudarib* shall apply; that is, a RW for "equity exposure in the banking book" shall apply.



76. In a *Mudarabah* investment in project finance, collateralization of the progress payments made by the ultimate customers (e.g. by means of a repayment account) can be used to mitigate the exposure to unsatisfactory performance by the *Mudarib*.
77. A NIFI may also place liquid funds with another NIFI on a short-term *Mudarabah* basis in order to obtain a return on those funds. Such placements serve as an interbank market transaction with maturities ranging from overnight up to three months, but the funds may be withdrawn on demand before the maturity date, in which case the return is calculated proportionately on the basis of duration and amount. Although from a juristic point of view the amounts so placed do not constitute debts, since (in the absence of misconduct or negligence) *Mudarabah* capital does not constitute a liability for the institution that acts as *Mudarib*, in practice the operation of this interbank market requires that the *Mudarib* should effectively treat them as liabilities. Hence, a NIFI placing funds on this basis may treat them as cash equivalents and, for risk-weighting purposes, apply the RW applicable to the *Mudarib* as counterparty.

## **2.6 Treatment of an Exposure Covered by Multiple CRM Techniques**

78. If an exposure is covered by multiple CRM techniques (e.g. an exposure partially covered by both collateral and a guarantee), the NIFI shall segregate the exposure into segments covered by each type of CRM technique. The calculation of risk-weighted assets will be made separately for each segment. Similarly, if a single CRM has differing maturities, they should also be segregated into separate segments.

## **2.7 Recognition of Ratings by ECAI**

79. Ratings issued by CBN-approved ECAIs are to be used by NIFI for calculating capital requirements under the Standardized Approach.

## **3.0 COMMODITY MURABAHAH TRANSACTIONS**

80. This section sets out the minimum capital requirements to cover the credit risks arising from financing contracts that are based on the *Shari'ah* rules and principles of Commodity *Murabahah* Transactions (CMT), either in the inter-bank market or to other customers.
81. A NIFI can be involved in CMT-based financing in the following forms;
  - (a) CMT for inter-bank operations for managing short-term liquidity surplus (i.e. selling and buying of *Shari'ah*-compliant commodities through *Murabahah* transactions, which is commonly termed “placement” in conventional institutions) or where the counterparty is the Central Bank of Nigeria offering a *Shari'ah*-compliant lender of last resort and/or a standing facility for effective liquidity management. Such placement/financing is referred to as “Commodity *Murabahah* for Liquid Funds (CMLF)”

(b) CMT for providing financing to counterparty by a longer-term commodity *Murabahah* where the counterparty immediately sells the commodities on the spot market is referred to as “Commodity *Murabahah* Financing (CMF)”.

82. CMLF is a tool for liquidity management for NIFI in order for them to invest their surplus liquid funds on a short-term basis with other market players, within or outside Nigeria. In this type of transaction, the RW will be influenced by the credit standing of the counterparty receiving the funds and the duration of the placement.

### **3.1 Capital Requirements for CMT**

83. Based on the general CMT structures, the transactions can pass through several important phases, each of which has different risk implications. Thus, a NIFI is exposed to different risks in different phases of the CMT. Consequently, it is crucial for a NIFI to recognize and evaluate the overlapping nature and transformation of risks that exist between various types of risks. Since the dynamism of risk exposure through the phases of CMT is unique, NIFIs should break down the contractual timeline for CMT while managing the risks in each phase.

#### **3.2.1 Credit Risk Weight for Commodity Murabaha Transactions**

84. As in both CMLF and CMF, a binding promise from the customer exists to purchase the commodity; a NIFI will be exposed to default on the customer’s obligation to purchase. In the event of default by the customer, the NIFI will dispose of the asset to a third party; that is, the credit risk will be mitigated by the asset in possession as collateral, net of any haircut. The exposure shall be measured as the amount of the total acquisition cost to the NIFI for the purchase of commodities, less the market value of the commodities as collateral, subject to any haircut and specific provisions, if any. The RW of the counterparty shall be applicable to the resultant receivables, and would be based on credit ratings issued by a recognized ECAI. In the case of an unrated counterparty, the applicable RW will be 100%.

### **4.5 Capital Requirements for Sukuk**

85. This section sets out the minimum capital requirements to cover the credit risk arising from the holding of a *Sukuk* in the “banking book” by a NIFI. CBN has the discretion to specify measurement approaches as it thinks appropriate for other types of *Sukuk* which are not listed in this sub-section, provided they are approved by a relevant *Shari’ah* board. For unrated *Sukuk* that use a combination of more than one of the *Shari’ah*-compliant contracts, the capital requirement will be calculated taking into account the risk implications of the overall structure.
86. As in principle, *Sukuk* are externally rated, the relevant risk weight will be based on the ECAI ratings in accordance with the standardized approach covered in this Guidance Notes. It is implied that ECAI has taken into account the structure and other features of

*Sukuk* while assigning the ratings. Where there are no acceptable ECAI ratings, the RWs will be determined on the basis of the underlying assets as set out in paragraph 88, which may involve market risk as well as credit risk.

87. Though, the RWs suggested in the following are based on an acceptable ECAI rating, a NIFI shall have methodologies that enables it to assess the credit risk involved in securitization exposures at individual and portfolio levels. A NIFI shall assess exposures, regardless of whether they are rated or unrated, and determine whether the RWs applied to such exposures under the standardized approach, which are appropriate for their inherent risk. In the instances where a NIFI determines that the inherent risk of such an exposure, particularly if it is unrated, is significantly higher than that implied by the RW to which it is assigned, the NIFI shall consider the higher degree of credit risk in the evaluation of its overall capital adequacy.
88. NIFIs shall apply risk weights to *Sukuk* issued by Governments as follows;
- a) 0% risk weight for Sovereign *Sukuk*
  - b) 20% risk weight for State Government *Sukuk* that meets the eligibility criteria for classification as liquid assets by the CBN;
  - c) 50% risk weight for State Government *Sukuk* that did not meet the eligibility criteria for classification as liquid assets by the CBN.
  - d) 100% risk weight for Corporate *Sukuk*

## APPENDIX A: SUPERVISORY SLOTTING FOR NIFI's PRODUCTS

INTERNAL RATING		Strong	Good	Satisfactory	Weak
<b>Financials</b>					
Market conditions		Few competitors or substantial and durable advantage in location, cost or technology Demand is strong and growing	Few competitors or better-than-average location, cost or technology, but this situation may not last Demand is strong and stable	Project/business venture has no advantage in location, cost or technology Demand is adequate and stable	Project/business venture has worse-than-average location, cost or technology Demand is weak and declining
Financial ratios		Strong financial ratios considering the level of project/business venture risk; very robust economic assumptions	Strong to acceptable financial ratios considering the level of project/business venture risk; robust project/business venture economic assumptions	Standard financial ratios considering the level of project/business venture risk	Aggressive financial ratios considering the level of project/business venture risk
Stress analysis		The project/business venture can meet its financial obligations under sustained, severely stressed economic or sectoral conditions	The project/business venture can meet its financial obligations under normal stressed economic or sectoral conditions. The project/business venture is only likely to	The project/business venture is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn	The project/business venture is likely to default unless conditions improve soon

			default under severe economic conditions		
<b>Financing Structure</b>					
Duration of the contract compared to the duration of the project/ business venture		Useful life of the project/ business venture significantly exceeds tenor of the financing contract	Useful life of the project/ business venture exceeds tenor of the financing contract	Useful life of the project/ business venture exceeds tenor of the financing contract	Useful life of the project/ business venture may not exceed tenor of the contract
Payment structure of selling price (Note: Applicable to <i>Istisna`</i> only)		Partly in advance and in installments	Installments	Installments with limited bullet payment	Bullet payment or in installments with balloon structure (higher instalment amounts towards end of the contract)
<b>Political and Legal Environment</b>					
Political risk, including transfer risk, considering project/business venture type and mitigants		Very low exposure; strong mitigation instruments, if needed	Low exposure; satisfactory mitigation instruments, if needed	Moderate exposure; fair mitigation instruments	High exposure; no or weak mitigation instruments
<i>Force majeure</i> risk (war, civil unrest, etc.)		Low exposure	Acceptable exposure	Standard protection	Significant risks, not fully mitigated
<b>Political and Legal Environment (cont'd)</b>					
Government support and project/business		Project/business venture of strategic	Project/business venture considered	Project/business venture may not be strategic	Project/business venture not key to the

venture's importance for the country over the long term		importance for the country (preferably export-oriented) Strong support from government	important for the country Good level of support from government	but brings unquestionable benefits for the country Support from government may not be explicit	country No or weak support from government
Stability of legal and regulatory environment (risk of change in law)		Favorable and stable regulatory environment over the long term	Favorable and stable regulatory environment over the medium term	Regulatory changes can be predicted with a fair level of certainty	Current or future regulatory issues may affect the project/business venture
Acquisition of all necessary supports and approvals for such relief from local content laws		Strong	Satisfactory	Fair	Weak
Enforceability of contracts, collateral and security		Contracts, collateral and security are enforceable	Contracts, collateral and security are enforceable	Contracts, collateral and security are considered enforceable even if certain non-key issues may exist	There are unresolved key issues in respect of actual enforcement of contracts, collateral and security
<b>Transaction Characteristics</b>					
Design and technology risk		Fully proven technology and design	Fully proven technology and design	Proven technology and design start-up issues are mitigated by a strong completion package	Unproven technology and design; technology issues exist and/or complex design
<b>Construction Risk</b> (for project finance only)					

Permitting and siting		All permits have been obtained	Some permits are still outstanding but their receipt is considered very likely	Some permits are still outstanding but the permitting process is well defined and they are considered routine	Key permits still need to be obtained and are not considered routine. Significant conditions may be attached
Type of construction contract		Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)	Fixed-price date-certain turnkey construction EPC	Fixed-price date-certain turnkey construction contract with one or several contractors	No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors
Completion guarantees		Substantial liquidated damages supported by financial substance and/or strong completion guarantee from sponsors with excellent financial standing	Significant liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Adequate liquidated damages supported by financial substance and/or completion guarantee from sponsors with good financial standing	Inadequate liquidated damages or not supported by financial substance or weak completion guarantees
<b>Construction Risk</b> (for project finance only) (cont'd)					
Track record and financial strength of contractor in constructing similar project/business ventures		Strong	Good	Satisfactory	Weak
<b>Operating Risk</b> (for project finance only)					

Scope and nature of operations and maintenance (O&M) contracts		Strong long-term O&M contract, preferably with contractual performance incentives and/or O&M reserve accounts	Long-term O&M contract and/or O&M reserve accounts	Limited O&M contract or O&M reserve account	No O&M contract: risk of high operational cost overruns beyond mitigants
Operator's expertise, track record and financial strength		Very strong or committed technical assistance of the Sponsors	Strong	Acceptable	Limited/weak, or local operator dependent on local authorities

<b>Off-take Risk</b> <i>(for project finance only)</i>				
(a) If there is a take-or-pay or fixed-price off-take contract	Excellent creditworthiness of off-taker; strong termination clauses; tenor of off-take contract comfortably exceeds the maturity of the financing contract	Good creditworthiness of off-taker; strong termination clauses; tenor of off-take contract exceeds the maturity of the financing contract	Acceptable financial standing of off-taker; normal termination clauses; tenor of off-take contract generally matches the maturity of the financing contract	Weak off-taker; weak termination clauses; tenor of off-take contract does not exceed the maturity of the financing contract
(b) If there is no take-or-pay or fixed-price off-take contract	Project produces essential services or a product sold widely on a world market; output can readily be absorbed at projected prices even at lower than historic market growth	Project produces essential services or a product sold widely on a regional market that will absorb it at projected prices even at historical growth rates	Product is sold on a limited market that may absorb it only at lower than projected rates	Project output is demanded by only one of a few buyers or is not generally sold on an organized market



	rates			
<b>Supply Risk</b> ( <i>for project finance only</i> )				
Price, volume and transportation risk of feed-stocks; supplier's track record and financial strength	Long-term supply contract with supplier of excellent financial standing	Long-term supply contract with supplier of good financial standing	Long-term supply contract with supplier of good financial standing – a degree of price risk may remain	Short-term supply contract or long-term supply contract with financially weak supplier – a degree of price risk definitely remains
<b>Supply Risk</b> (cont'd) ( <i>for project finance only</i> )				
Reserve risks (e.g. natural resource development)	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Proven reserves can supply the project adequately through the maturity of the financing contract	Project relies to some extent on potential and undeveloped reserves
<b>Strength of Sponsor</b>				
Sponsor's (or partner's, in the case of <i>Musharakah</i> ) track record, financial strength and country/sector experience	Strong sponsor (partner) with excellent track record and high financial standing	Good sponsor (partner) with satisfactory track record and good financial standing	Adequate sponsor (partner) with adequate track record and good financial standing	Weak sponsor (partner) with no or questionable track record and/or financial weaknesses
Sponsor's (or partner's, in the case of <i>Musharakah</i> ) support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary	Strong. Project/business venture is highly strategic for the sponsor (partner) – i.e. core business and long-term strategy	Good. Project/business venture is strategic for the sponsor (partner) – i.e. core business and long-term strategy	Acceptable. Project/business venture is considered important for the sponsor (partner) – i.e. core business	Limited. Project/business venture is not key to sponsor(partner)'s long- term strategy or core business
<b>Security Package</b>				
Assignment of contracts and accounts*	Fully comprehensive	Comprehensive	Acceptable	Weak

Pledge of assets, taking into account quality, value and liquidity of assets*	First perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Perfected security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Acceptable security arrangement in all project assets, contracts, permits and accounts necessary to run the project	Little security or collateral for IIFS; weak negative pledge clause
IIFS' control over cash flow (e.g. independent escrow accounts)	Strong	Satisfactory	Fair	Weak
Reserve funds (payment of selling price in <i>Istisnā`</i> , O&M, renewal and replacement, unforeseen events, etc.)	Longer than average coverage period, all reserve funds fully funded in cash	Average coverage period, all reserve funds fully funded in cash	Average coverage period, all reserve funds fully funded in cash	Shorter than average coverage period, reserve funded from operating cash flows

\*In *Musharakah*, the collateralization of underlying assets is restricted to losses arising from negligence and misconduct cases only.

## APPENDIX B: SUPERVISORY SLOTTING FOR DIMINISHING MUSHARAKAH

	Strong	Good	Satisfactory	Weak
<b>Financial Strength</b>				
Market conditions	The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is equal to or lower than forecasted demand.	The supply and demand for the business venture's type and location are currently in equilibrium. The number of competitive properties coming to market is roughly equal to forecasted demand.	Market conditions are roughly in equilibrium. Competitive properties are coming on the market and others are in the planning stages. The business venture's design and capabilities may not be state of the art compared to new project/ business ventures.	Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium. The business venture is losing tenants at <i>Ijarah</i> /lease expiration. New <i>Ijarah</i> /lease terms are less favorable compared to those expiring.
Stress analysis	The property's resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress.	The property can meet its financial obligations under a sustained period of financial stress. The property is likely to default only under severe economic conditions.	During an economic downturn, the property would suffer a decline in revenue that would limit its ability to fund capital expenditures and significantly increase the risk of default.	The property's financial condition is strained and is likely to default unless conditions improve in the near term.
<b>Cash-flow Predictability</b>				
(a) For complete and stabilized property	The property's leases are long-term with creditworthy Tenants, and their maturity dates are scattered. The property has a track record of tenant retention	Most of the property's leases are long-term, with tenants that range in creditworthiness. The property experiences a normal level of tenant turnover upon lease expiration. Its vacancy rate is low. Expenses are	Most of the property's leases are medium rather than long-term, with tenants that range in creditworthiness. The property experiences a moderate level of tenant turnover upon lease expiration.	The property's leases are of various terms, with tenants that range in creditworthiness. The property experiences a very high level

	upon lease expiration. Its vacancy rate is low. Expenses (such as maintenance, insurance, security, and property taxes) are predictable.	predictable.	Its vacancy rate is moderate. Expenses are relatively predictable but vary in relation to revenue.	of tenant turnover upon lease expiration. Its vacancy rate is high. Significant expenses are incurred in preparing space for new tenants.
(b) For complete but not stabilized property	Leasing activity meets or exceeds projection. The business venture should achieve stabilization in the near future.	Leasing activity meets or exceeds projections. The project should achieve stabilization in the near future.	Most leasing activity is within projections; however, stabilization will not occur for some time.	Market rents do not meet expectations. Despite achieving target occupancy rate, cash-flow coverage is tight due to disappointing revenue.
<b>Strong</b>	<b>Strong</b>	<b>Good</b>	<b>Satisfactory</b>	<b>Weak</b>
(c) For construction phase	The property is entirely pre-leased through the tenor of the contract or pre-sold to an investment-grade tenant or buyer.	The property is entirely pre-leased or pre-sold to a creditworthy tenant or investor.	Leasing activity is within projections but the building may not be pre-leased. The IIFS may be the permanent investor.	The property is deteriorating due to cost overruns, market deterioration, tenant cancellations or other factors. There may be a dispute with the party providing the permanent financing.
<b>Asset Characteristics</b>				
Location	Property is located in highly desirable location that is convenient to services that tenants desire.	Property is located in desirable location that is convenient to services that tenants desire.	The property location lacks a competitive advantage.	The property's location, configuration, design and maintenance have contributed to its difficulties.

Design and condition	Property is favored due to its design, configuration and maintenance, and is highly competitive with new properties.	Property is appropriate in terms of its design, configuration and maintenance. The property's design and capabilities are competitive with new properties.	Property is adequate in terms of its configuration, design and maintenance.	Weaknesses exist in the property's configuration, design or maintenance.
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