

## **GUIDELINES ON CREDIT TRANSACTIONS AND EXPOSURES WITH CONNECTED PARTIES FOR LABUAN BANKS**

### **1.0 Introduction**

- 1.1 The Guidelines on Credit Transaction and Exposures with Connected Parties for Labuan Banks (the Guidelines) sets out the minimum parameters relating to credit transactions with connected parties including the roles and responsibilities expected of the management and the Board of Directors.

### **2.0 Applicability**

- 2.1 The Guidelines is applicable to all Labuan banks under the following categories:-
- (a) Labuan bank licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);
  - (b) Labuan Islamic bank licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and
  - (c) Labuan bank that has been given approval to undertake its business as a Labuan Islamic bank under Part VI of LIFSSA.
- 2.2 For avoidance of doubts, the requirements of the Guidelines are also applicable to Labuan banks operating as branches. Where policies and procedures as implemented by their head office are not comparable with the requirements of the Guidelines, the requirements prescribed herein shall prevail. Nevertheless, Labuan banks are encouraged to adopt any higher standards implemented by their head office.

### **3.0 Legal Provision**

- 3.1 The Guidelines is issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSSAA) in respect of Labuan banking business, Labuan investment banking business, Labuan Islamic banking business or Labuan Islamic Investment banking business for the purpose of clarifying prudential requirements in relation to credit transactions and exposures with connected parties for Labuan banks.
- 3.2 Any person who fails to comply with the Guidelines may be guilty of an offence punishable under Section 36B and 36G of the LFSSAA.

## 4.0 Effective Date

- 4.1 The Guidelines is effective from **1 October 2012** and supersedes the Guidelines on Connected Lendings issued on 8 April 1997.

## 5.0 Guiding Principles

- 5.1 As a general principle, all credit transactions must be extended on an arm's length basis. Credit exposures of Labuan banks should not be overly concentrated on a particular group of borrowers. The terms and conditions of the credit transactions must be appropriate, based on sound credit risk management practices which serve to safeguard the interests of its various stakeholders and in particular, depositors.
- 5.2 Labuan banks should establish a mechanism to monitor credit exposures to connected parties, whether individuals or companies, and take the appropriate steps to control, mitigate or reduce risks of connected transactions.
- 5.3 Labuan banks should ensure that the terms and conditions for credit transactions with connected parties are no more favorable than those granted to other counterparties of similar background and credit standing. The same principles should be applied in the administration of credit transactions with connected parties (e.g. credit review, provisioning, follow-up and recovery actions, etc) and credit exposures.
- 5.4 Labuan banks must have a robust system of internal controls to prevent credit transactions which would override established credit approval policies and procedures. This should include appropriate controls and a comprehensive monitoring and reporting mechanism to ensure that credit transactions with connected parties are subjected to rigorous credit reviews and the overall exposure to connected parties remains within acceptable levels.
- 5.5 The Board of Directors is ultimately responsible to ensure that risks associated with credit exposures to connected parties are effectively managed. Board members are also expected to play a significant role in ensuring the effective implementation of policies and procedures designed to control and manage risk exposures, and to promote sound business practices.

## 6.0 Definition and Scope

- 6.1 Unless specifically stated otherwise, a **connected party** refers to any of the following of a Labuan bank:

- (a) **Director**, whether as an executive director or otherwise, and whether or not receiving compensation, and his close relatives. This includes alternate directors where permitted by Labuan FSA.
- (b) **Controlling shareholder** and his close relatives.  
A person shall be deemed to be a controlling shareholder if he fulfils any of the following criteria, whether individually or with other persons acting in concert with him:
- (i) Controls more than 50% of the voting rights;
  - (ii) Holds more than 50% of the issued share capital whether directly or indirectly (excluding preference shares);
  - (iii) Controls the composition of the Board of Directors;
  - (iv) Has the power to appoint and/or remove all or a majority of the Board of Directors;
  - (v) Controls the controlling shareholder of the Labuan bank; or
  - (vi) Is a person in accordance with whose directions or instructions, a director of the Labuan bank or its holding company are accustomed to act.
- (c) **Executive officer** and his close relatives.  
An executive officer is defined as a person who is a member of management and/or controlling the activities of the Labuan banks (other than in the capacity as a director), whether or not the officer has an official title, or is entitled to salary or other compensation. Examples of such officers include, but are not limited to, the chief executive officer, chief operating officer or members of business and policy-making committees.
- (d) **Any officer** who is responsible for or has the authority to appraise and/or approve credit transactions or review the status of existing credit transactions, either as a member of a committee (e.g. Credit or Investment Committee) or individually, and his close relatives.
- (e) **Firms, partnerships, companies or any legal entities** which control, or are controlled by, any person (including close relatives in the case of individuals) listed in (a) – (d) above. For this purpose, ‘control’ shall be determined with reference to the criteria set out in paragraph 6.1(b).
- (f) **Firms, partnerships, companies or any legal entities** in which any person (including their close relatives in the case of individuals) listed in (a) – (d) above are interested as a director, partner, executive officer, agent or guarantor, and their subsidiaries or entities controlled by them.
- (g) Any person for whom the person listed (including their close relatives in the case of individuals) in (a) – (d) above is a guarantor.

- (h) Subsidiary of, or an entity controlled by, a Labuan banks, and its connected parties.
- 6.2 For the purpose of the Guidelines, the term “officer” shall exclude those that are not described in paragraphs 6.1(c) and 6.1(d) above.
- 6.3 **Person**, as defined under section 2 of LFSSA and LIFSSA, includes individuals, any corporation, partnership, a body of persons, a body of persons, corporate or unincorporated and corporation sole.
- 6.4 For connected parties who are individuals, close relative means those family members who may be expected to influence or be influenced by that individual, as well as dependents<sup>1</sup> of the individual. This includes the individual’s:
- (a) spouse and dependents of the spouse;
  - (b) child (including step children and adopted children) and spouse of the child;
  - (c) parent; and
  - (d) brother or sister and their spouses.
- 6.5 **Credit transaction** includes the extension of a credit facility as defined under section 86 of the LFSSA, leasing activity, off-balance sheet transactions that give rise to credit and/or counterparty risk, the underwriting and acquisition of equities and private debt securities (PDS), whether in the primary or secondary market, including Islamic credit facilities as defined under section 60 of LIFSSA, that give rise to credit and/or counterparty risk.
- 6.6 **Capital base**<sup>2</sup> follows the definition as prescribed under the Guidelines on Risk Weighted Capital Adequacy.
- 6.7 The principles and the requirements of the Guidelines should also be observed for credit transactions and credit exposures with connected parties effected through the Labuan bank’s subsidiaries or other entities controlled by the Labuan banks.

## 7.0 Credit Transactions with Connected Parties

- 7.1 Due care should be taken in entering into credit transactions with connected parties to ensure that the transactions are on an arm’s length basis. The following principles should be observed:-

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<sup>1</sup> This refers to any person who is financially dependent on the individual or his spouse for his livelihood, e.g. a person who receives financial assistance on a regular basis from the individual/spouse.

<sup>2</sup> Broadly, ‘capital base’ would comprise of the total capital Tier 1 + eligible Tier 2 Capital – investment in subsidiaries and holdings of other licensed institutions’ capital.

- (a) The creditworthiness of the connected party is not less than what is normally required of other persons;
- (b) The terms and conditions of credit transactions with connected parties should not be more favorable than those entered into with other counterparties with similar circumstances and creditworthiness, in respect of tenure, interest rate, amortization schedules and requirement for collateral;
- (c) The credit transaction should be in the interest of the Labuan banks; and
- (d) The credit transaction is approved by the Board of Directors with not less than three quarters of all the Board members present, and such approval is duly recorded in the minutes of the meeting.

7.2 The Board may delegate its authority to approve credit transactions with connected parties provided that:

- (a) The delegation should be limited to transactions that meet parameters to be set by the Board. These parameters should address, amongst other things, threshold limits, the nature of transactions and the connected parties involved in relation to which delegation is permitted;
- (b) The delegation and established parameters must be unanimously approved by the Board, with no less than three quarters of the Board members present;
- (c) Except as allowed under paragraphs 7.3 and 7.4 below, the authority should be delegated to a properly constituted committee which includes at least two non-executive directors who are independent of the transaction and whose composition has been approved by the Board. There should be a clear separation between this committee and the credit review committee (if such a committee is formed) pursuant to paragraph 8.3; and
- (d) All decisions made under the delegated authority must be properly recorded in the minutes of the committee meetings and reviewed on a regular basis by the Board.

7.3 For low valued personal consumption credit facilities as determined by the Board<sup>3</sup>, Labuan banks may delegate approving authority to at least two responsible officers of the licensed institution who are also independent of the transactions. Any delegation to individual officers should be duly approved by the Board in accordance with paragraph 7.2 (a), (b) and (d) of the guidelines. In addition, all such delegated credit decisions should be individually ratified by the Board, or a Credit Committee that is properly constituted in accordance with paragraph 7.2(c) of the guidelines.

7.4 Delegated authority to responsible officers is also allowed for derivative transactions such as interest rate swaps, currency swaps, currency forwards and

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<sup>3</sup> Examples include motor vehicle loans, mortgage loans, personal loans and credit card facilities which are below a limit to be set by the Board.

options which are entered into with group entities for risk management purposes. Labuan banks must nevertheless ensure that:

- (a) The creditworthiness of the relevant group entity is not less than what is normally required for similar transactions with third parties; and
- (b) The transactions (including applicable terms and conditions) are consistent with the Labuan bank's internal risk management policies and procedures.

7.5 The administration and management of credit risk for exposures resulting from credit transactions with connected parties (including debt collections, credit reviews, provisioning, write-offs, follow-up actions, legal actions and concentrations of exposures to connected parties) should similarly adhere to approved policies and procedures applied to other counterparties.

7.6 A connected party should abstain from participating directly or indirectly in the deliberation and decision-making process involving a credit transaction and management of the credit exposures (e.g. credit reviews, investment reviews etc) in which he has an interest.

## **8.0 Controls over Credit Transactions with Connected Parties**

### **Oversight by Board of Directors**

8.1 The Board of Directors is responsible to establish a clear written policy on credit transactions and management of credit exposures with connected parties. The policy should be periodically reviewed and any changes to the policy should be approved by the Board of Directors.

8.2 The Board of Directors should ensure that a proper mechanism is in place to implement policies and procedures relating to the control and management of risk exposures and risk of malpractices associated with connected party transactions.

8.3 Credit transactions and credit exposures with connected parties must be regularly reviewed, and monitored by the Board of Directors. The Board may delegate this function to a credit review committee, subject to the following requirements:

- (a) The committee is chaired by a member of the Board (either executive or non-executive) or any person appointed by the Board, who does not have a material credit transaction with the Labuan banks, and must not be empowered to approve credit or investments. The Board shall determine the composition of the committee and the committee should report directly to the Board; and
- (b) The committee should comprise persons experienced in credit and risk management, preferably drawn from those having specialised skills in managing various elements of the credit investment activities. Such persons

should be able to evaluate and make recommendations to the Board on risk management issues, the level of risk exposure and appropriate risk mitigants in relation to transactions with connected parties.

- 8.4 To facilitate the Board in carrying out its functions, management or the credit review committee referred to in paragraph 8.3 should submit regular reports to the Board on:
- (a) Credit transactions with connected parties;
  - (b) The status and aggregate credit exposures to each connected party; and
  - (c) Material concentrations.

### **Policy on Credit Transactions with Connected Parties**

- 8.5 Established internal policies and procedures regarding credit transactions and management of credit exposures with connected parties must specifically address all material aspects and should cover, at a minimum, the following areas:
- (a) The types of credit transactions and credit exposures that are subject to the policies and procedures. These should follow the categories as defined in the Guidelines but Labuan banks may include any other types of credit transactions;
  - (b) A connected party should be clearly defined in line with the definition provided in the Guidelines. Where appropriate, the Board may include other parties it considers as having the ability to exert significant influence over the Labuan banks;
  - (c) Conditions, including interest rates, and other terms and conditions that must be complied with for credit transactions with connected parties.
  - (d) All transactions with connected parties must be approved by the Board or a committee properly constituted by the Board in line with paragraph 7.1. The write-off of connected party exposures exceeding an amount as determined by the Board should also be subject to the Board's approval;
  - (e) Credit limits, applicable both for exposures at the individual/entity level and for aggregated exposures to connected parties within the same group or that are otherwise affiliated. The limits should be appropriate to avoid excessive exposures to connected parties that will increase risks to the Labuan banks beyond prudent levels. Such limits may be lower than the permitted under paragraph 9.1 of this Guidelines;
  - (f) Procedures for the processing and monitoring of credit transactions and credit exposures with connected parties, including, but not limited to:
    - (i) Procedures for the effective management and review of credit transactions and credit exposures;
    - (ii) clear controls prohibiting a person with an interest in the credit transaction and/or credit exposure from participating in the deliberation, decision making or management of the transaction and/or exposure;



- (iii) Appropriate mechanisms to identify individual and aggregate exposures to connected parties to ensure compliance with approved limits; and
  - (iv) Procedures for regular reporting to the management and Board on credit transactions and credit exposure levels with connected parties as well as the status of such exposures.
- (g) Internal controls and other procedures to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

### **Monitoring of Connected Lending**

- 8.7 A Labuan bank should institute appropriate processes that will facilitate its timely identification of parties which are connected to it. Such processes may include declarations by directors, key officers and controlling shareholders of their affiliations and close relatives. The list of connected parties should be updated regularly.
- 8.8 A Labuan bank must ensure the presence of a robust system to identify measure and monitor credit exposures to a connected party and compliance with established policies and procedures, as well as to identify exceptions.
- 8.9 A Labuan bank should establish a system of independent, on-going assessment of credit transactions and credit exposures with a connected party to ensure their compliance with established limits. The results of such reviews should be communicated directly to the Board and senior management.
- 8.10 The internal audit function should conduct regular reviews into credit transactions and the administration and management of credit exposures with connected parties to ensure compliance with established policies and procedures. The resulting audit reports should be submitted directly both to the Board and the Audit Committee.
- 8.11 Any exceptions should be reported promptly to the appropriate level of management as established in the policies and procedures. Material exceptions should be immediately reported directly to the Board or Audit Committee and concurrently to Labuan FSA.

### **9.0 Limits on Credit Exposures with Connected Party**

- 9.1 Total outstanding credit exposures to all connected parties except those exempted under paragraph 10.2 below, shall not exceed 100 percent of the capital base or 25 percent of total outstanding credit exposures, whichever is lower.



- 9.2 For purposes of the Guidelines, credit exposures include both outstanding and unutilized credit arising from credit transactions with connected parties.
- 9.3 For off-balance sheet transactions, the on-balance sheet equivalent (credit equivalent) value of the credit exposure shall be determined by applying a conversion factor to the nominal principal amount of the off-balance sheet exposures. The conversion factor shall be based on the nature of the off-balance sheet exposures as listed in the Explanatory Notes of Guidelines on Risk-Weighted Capital Adequacy. For over-the-counter (OTC) market-related contracts, credit exposures shall be determined based on the current exposure method.
- 9.4 Labuan banks may compute exposures arising from derivative transactions with the same connected party on a net basis if it satisfies the conditions and requirements set out in paragraph 7.6 in the Explanatory Notes of the Guidelines on Risk Weighted Capital Adequacy.
- 9.5 If Labuan FSA is satisfied that a Labuan bank is unable to comply with the minimum conditions and requirements prescribed to recognize the bilateral netting arrangements for its derivative transactions, Labuan FSA may direct the Labuan banks to cease computing its exposures on a net basis.

## **10.0 Exemptions from Specific Requirements of the Guidelines**

- 10.1 The following are exemptions from specific requirements of the Guidelines: -
- (a) Credit facilities extended under schemes of service for staff and executive directors are exempted from paragraphs 7.1(a) and 7.1(b); and
  - (b) Credit transactions with subsidiaries are exempted from paragraph 7.1(b).
- 10.2 Credit exposures arising from the following credit transactions with connected parties are exempted from the limit under paragraph 9.1:
- (a) Credit facilities extended under schemes of service for staff and executive directors;
  - (b) Credit facilities provided to finance the purchase of a house for own occupation by an individual connected party or his close relatives;
  - (c) Credit facilities provided to finance the education of children of the connected party;
  - (d) Credit transactions, partially or entirely secured by cash or bank deposits. The exemption shall be limited to the amount secured by the said security;
  - (e) Credit facilities provided under special or compassionate circumstances, to an executive officer, or officer, subject to a maximum amount at any one time not exceeding 6 months' remuneration of the executive officer or officer concerned;

- (f) Credit transactions associated with debt-to-equity conversion schemes in which the Labuan bank's holding does not exceed 33% of the restructured company's nominal paid-up capital. Labuan banks are, however, prohibited from entering into new/additional credit transactions with the company concerned; and
- (g) Short-term intra-group liquidity facilities with tenures not exceeding one year.

## **11.0 Records**

- 11.1 A Labuan bank is required to maintain the necessary records which will identify connected parties, related interests and specify their credit exposures. These records should be updated.
- 11.2 Records regarding each credit transaction with a connected party shall cover, at a minimum, the following:
  - (a) Name of borrower;
  - (b) Name of connected party;
  - (c) Relationship;
  - (d) Date approved and reviewed;
  - (e) Purpose of the credit transaction;
  - (f) Type of exposure;
  - (g) Amount of approved transaction;
  - (h) Outstanding amount or carrying value;
  - (i) Internal credit rating;
  - (j) Terms and conditions; and
  - (k) Security.
- 11.3 These records should be available for inspection by Labuan FSA and/or external auditors at any time.

## **12.0 Regulatory Reporting**

- 12.1 A Labuan bank must immediately report to Labuan FSA the following:-
  - (a) Any significant non-compliance with policies and procedures in line with paragraph 8.11; and
  - (b) Any credit transaction with connected parties carried out not complying with the limits specified by Labuan FSA under the Guidelines.
- 12.2 The Board is responsible to ensure adequate procedures are in place and effectively implemented to secure the accuracy of reports submitted Labuan FSA.

## 13.0 Disclosure

13.1 A Labuan bank should submit to Labuan FSA on a semi-annual basis, information, regarding credit exposures arising from credit transactions with connected parties as per the **Appendix 1**. At a minimum, the information should include:-

- (a) the aggregate value of outstanding credit exposures with connected parties;
- (b) the percentage of outstanding credit exposures to connected parties as a proportion of total credit exposures; and
- (c) the percentage of outstanding credit exposures with connected parties which is non-performing or in default.

## 14.0 Capital Adequacy Treatment

14.1 The amount of credit exposures to a connected party may be deducted from the regulatory capital, or the Labuan bank may be required to collateralise the exposures, if Labuan FSA is of the opinion that the credit transaction was undertaken in a manner that is inconsistent or not compliant with, the principles and requirements set out in the Guidelines.

## 15.0 Other Connected Party Transactions

15.1 While the Guidelines addresses credit transactions and exposures with connected parties, the principles herein should be generally observed for all other connected party transactions<sup>4</sup>, particularly in relation to the approval, control (including monitoring and oversight) and limits (where appropriate) of such transactions.

## 16.0 Credit Facilities Granted to Officers other than Connected Parties

16.1 "Officer" is defined in Section 2 of LFSSA and LIFSSA to include, in relation to a corporation:

- (a) a director, secretary or employee of the corporation including the principal officer;
- (b) a receiver and manager of any part of the undertaking of the corporation appointed under a power contained in any instrument; and
- (c) a liquidator of the corporation appointed in a voluntary winding-up;

but does not include-

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<sup>4</sup> Examples of other connected party transactions include the procurement of goods and services, lease rentals, consulting or professional services with connected parties, the purchase or sale of real estate and other capitalized leases.

- (i) a receiver who is also not a manager;
- (ii) a receiver and manager appointed by the Court; and
- (iii) a liquidator appointed by the Court or by the creditors.

Labuan Financial Services Authority  
1 October 2012

### Semi-annual Reporting on Credit Transactions and Exposures with Connected Parties

(To be submitted to Supervision and Enforcement Department, Labuan FSA no later than 3 weeks after the reporting date)

Name of Labuan Bank	
For position as at	

	Total Outstanding Value (USD '000)	Total number of connected party accounts / counterparty	Total exposure (total outstanding + unutilised limit)	Total credit exposure which is non-performing or in default
Credit facility & leasing (except guarantee)				
Off-balance sheet exposures <sup>1</sup>				
Equities and Private Debt Securities held				
<b>TOTAL</b>				
<b>Total exposure to connected parties as % of capital base</b>				
<b>Total exposure to connected parties as % of total outstanding credit exposures</b>				

<sup>1</sup> Off-balance sheet transactions that give rise to credit and/or counterparty risk. These transactions also include guarantees, underwriting obligations, etc.