

## **6- RULES AND REGULATIONS FOR DIRECT INVESTMENT**

- A) Instructions No. (2/IBS/142/2003) concerning the rules and regulations for direct investment of Islamic banks.
- B) Circular No. (2/IBS/187/2006) Concerning the set of guidelines taken into account while considering Islamic banks applications for exemption from the maximum limits established for direct investment and financial investments.
- C) Circular No. (2/IBS/219/2008) Concerning the guidelines to be taken into consideration while studying banks' requests for exemption from the prescribed maximum limits of financial investments.

**Instructions No. (2/IBS/142/2003)  
Concerning the rules and regulations for direct  
Investment of Islamic Banks**

Islamic banks investment activity meant to be addressed by these instructions is the investment business practiced by the Islamic banks for their own account in non-banking or non-financial areas, such as trade and real estate, which results in the banks acquisition of moveable and immovable assets, either for the purposes of trading seeking to generate profits from the selling such assets to customers, or for investment in order to achieve periodic returns and / or benefit from capital appreciation.

These instructions do not apply to the financial investment in the securities portfolio, which comprises financial instruments like shares, finance sukuk and other financial investment instruments issued by other parties, as these are separately addressed in the instructions concerning “the organization of financial investment policy for Islamic banks”.

It is understood that the direct investment business involves additional risks beside the risks associated with the normal banking and financial activities practiced by banks, such as finance and financial investment, including normal risks, market risks and liquidity risks emanating from these activities. Therefore, these activities must be practiced within the framework of investment policies that incorporate the appropriate strategies for these areas of business, and which are based on sound grounds that take into account the type and size of risk in each activity and the general and economic conditions within which the relevant sectors operate, thus ensuring the mitigation of the risks banks may encounter in these fields. Prudent management of business in this connection is of prime importance for banks compared to other economic institutions that practice this type of business, because those banks are bound to protect the interests of funds of their depositors which represent part of the wealth of the society that must be preserved and grown. Accordingly, the appropriate methods and techniques must be adopted to avoid undue losses, and banks are required to use such funds in developing various economic sectors.

Based on the rules of article (86) of law No.(32) of the year 1968 concerning Currency, the Central Bank of Kuwait & the Organization of the Banking Business and the laws issued in amendment thereof, which authorizes the Islamic banks to practice direct investment activities in accordance with the rules set-up by the central Bank Board of Directors, and the rules of article (98) of the said law which authorizes the Central Bank to determine for the Islamic banks the maximum limit of the transactions pertinent to a certain activity,

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A) Instructions No. (2/IBS/142/2003) concerning the rules and regulations for direct investment of Islamic banks.

the Central Bank Board of Directors has resolved at its meeting of 19/10/2003 to issue the following rules and regulations concerning Islamic banks direct investment, and which represent the minimum rules that must be observed by Islamic banks when practicing direct investment activities.

**First: Controls Regulating Direct Investment Activities:**

1- Banks must set-up a written investment policy approved by the board of directors for each of the direct investment activities practiced by the bank, so that such policy will be the basis for taking the appropriate decisions in this respect. This policy must observe the following rules, at minimum:

A) Creating balance between the objective of maximizing the return on the investment and the developmental role of the banks in contributing to the growth of the other economic sectors, as they are licensed to mobilize the savings of the society segments. Hence, banks may not speculate on the prices of the assets constituting the object of the investment, and must refrain from any practices causing harm to the conditions of healthy competition with other economic institutions practicing the same business.

On the other hand, the investment policy must balance between minimizing risk, on the one hand, and achieving the appropriate return on the investment, on the other hand.

B) The bank must adopt a sound policy in managing its assets and liabilities in a manner ensuring the appropriate level of liquidity to meet contingent needs without having to liquidate assets on the short term, which may result in losses for the bank, taking into account that a part of the direct investment may be concentrated in real estate properties which are not usually easily disposable.

C) Minimizing investment risks (normal risks, market risks, etc..), basically by thorough study of the subject assets markets, their developments and future outlook under the general and economic conditions of relevant to these markets. The policies must include the maximum limits for the types of direct investments and the risks associated therewith.

In this respect, the bank must take into account the size of the similar assets constituting the object of the lease financing (ending-up with acquisition), as these assets are considered free hold of the bank (the lessor) according to the Shareea'a rules, and hence the bank bears the risks associated with such ownership.

- 2- The bank must create balance between its direct investment policies and finance policy in a manner that does not affect the role of the bank in extending finance to various economic sectors. The bank must also coordinate these policies, to the extent possible, in relation to the assets the bank needs for executing the finance transactions with customers.
- 3- The bank must establish an independent specialized unit, or a specialized unit within the risk management department the bank is committed to establish in accordance with the “General Guidelines for the Internal Control Systems in Islamic banks and External Auditors Reports on the Evaluation of Those Systems”. The mentioned department shall be responsible for identifying, measuring and managing the types of risks inherent in the direct investment, and shall conduct the necessary studies in this regard. This unit should be provided with professional staff of appropriate experience and capabilities to manage the risks in the areas of the above mentioned activities.

### **Second: Maximum Limits for Direct Investment:**

The total book value of the assets constituting the object of the direct investment may not exceed 100% of the capital of the bank in its comprehensive concept, as explained in the instructions issued in connection with the capital adequacy ratio for Islamic banks. The following rules must also be observed:

- A) The book value of the assets constituting the object of the direct real estate investment, whether for trading or for investment purposes, may not exceed 50% of the capital in its comprehensive concept, and provided that the amount of investment in one single property may not exceed 10% of the capital in its comprehensive concept.
- B) The book value of the assets constituting the object of commercial investment may not exceed 10% of the capital in its comprehensive concept.
- C) The book value of the assets constituting the object of any other type of direct investment other than those mentioned in items (a) and (b) above, may not exceed 10% of the capital in its comprehensive concept.

When calculating the above ratios, the book value of the bank’s investments in the capital of subsidiaries and affiliates practicing similar business, must be added to the numerator of the ratio.

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In the event the banks desires to exceed the above mentioned ratios, the bank must obtain the Central Bank's prior approval in writing by submitting an application supported by the justifications and reasons for which the excess is requested and the period of the excess, noting that such cases must be kept to the minimum and to events of absolute need<sup>(1)</sup>.

### **Third : General Rules:**

- 1- Each direct investment activity must be practiced through an independent department manned with professional staff of high efficiency and appropriate experience to manage this activity. The organization structure of the bank must show the structure of these departments.
- 2- A system of powers and responsibilities must be set-up for the management of direct investment activity. Such a system must be approved by the bank board of directors, and must include the formulation of necessary committees, with clear and accurate definition of the method of their work and the powers delegated to them and to various managerial levels entrusted with the responsibility of exercising direct investment activities. In defining these powers, the bank must differentiate between the local and foreign direct investments. Controls must be put in place for exceptions to these powers.
- 3- The bank must take necessary actions to ensure compliance, by all managerial levels concerned with the implementation of the established investment policies, including the maximum limits and the limits of established powers and responsibilities.
- 4- The bank must perform the following:
  - a) Review the investment policies for direct investment periodically, (at least once annually), and introduce the necessary amendments thereto in the light of the general policy of the bank and the developments in the respective markets.
  - b) Provide the Central Bank of Kuwait with investment policies in the above mentioned areas, as well as with any future amendments thereto.
- 5- The executive management of the bank must prepare quarterly reports for presentation to the bank's board of directors on each of the bank's direct investment. The reports must include an evaluation of the bank's investments in these areas, the profits and losses resulting there-from and the future directions in respect of these investments.

(1) Circular No. (2/IBS/187/2006) issued on 22/3/2006 and falling within item [B] of this section, includes the set of guidelines taken into account while considering banks applications for exemption from the maximum limits established for direct investment and financial investments.

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In addition to the above mentioned quarterly reports, the chief executive officer of the bank must be provided with monthly reports, or with shorter- period reports, showing the evaluation of these investments and the profits and losses resulting there-from.

**Fourth :** These instructions shall be in effect from the date of their notification.

**GOVERNOR**

*Safar 22, 1427 H  
March 22, 2006*

**THE CHAIRMAN,**

**Circular To All Conventional Banks  
(2/IBS/187/2006)**

Referring to the Central Bank of Kuwait's instructions concerning the rules and regulations for direct investment of Islamic banks, and organization of Islamic banks financial investment policy, which says that if any bank need to exceed any of the maximum limits established under those instructions, then such a bank will have to obtain the Central Bank's written approval in advance, depending on an application delivered from the bank to the Central Bank, explaining the justifications and reasons for which it is requesting the approval for excess.

**While considering banks applications for exemption from the maximum limits established for direct investment and financial investments, the Central Bank of Kuwait will take into consideration the following set of guidelines:**

**First : Direct Investment:**

- 1- How far does the applicant bank compliant with the laws and regulatory instructions issued by the Central Bank, and the absence of any breaches that have a tangible negative impact or are of a recurrent nature, especially in the area of financial investment.
- 2- Relevant to the previous item, the Central Bank of Kuwait will take in consideration the bank's financial penalties for breaching the regulations and the limits established under its instructions, as well as the frequency of applying such penalties.
- 3- The evaluation of the overall position of the bank comprising all of its elements, as assessed through evaluating its performance according to CAMEL Approach.
- 4- Approval of the exemption from the maximum limits established for the real estate or commercial investments, or any other direct investment activities, shall not be granted if the bank has exceeded those established limits in breach of the relevant instructions.
- 5- Any other relevant considerations deemed appropriate by the Central Bank, other than the above considerations.

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## **Second: Financial Investment:**

- 1- As a matter of principle, a bank may have only one subsidiary in Kuwait and more than one subsidiary operating abroad in the same field of business, with the understanding that a bank will have only one subsidiary over which it has control, and which operates in the same field of business in the country it is located in, for serving the bank's purposes. Exemption from this rule will be allowed only on the grounds of strong justifications convincing for the Central Bank, such as the cases of business expansion according to a prudent business strategy, or the need for maintaining the same level of presence for the bank in foreign markets.
- 2- Relevant to the previous item is that exemption may not be repeated for the same type of cases, (such as the type of business) or geographically (in terms of the country in which the investment is located, whether internally or externally).
- 3- In the cases where the bank has subsidiaries or sister companies operating in the same field of business and in the same countries where the investment is located, it would seem that there is no justification for obtaining a new exemption.
- 4- Among the acceptable justifications for exemption is the participation of local banks in one of the companies established for serving the collective purposes of the banks. An example of this is the local banks' participation in (K-Net).
- 5- If the bank desires to increase its participation in these companies, the bank must submit a new application to Central Bank of Kuwait for obtaining its approval of such increase before entering into it. The application must be accompanied with the justifications for such increase.<sup>(1)</sup>
- 6- As regards participations in companies (other than subsidiaries) which exceed the maximum established limit (10% of the capital of the investee company), and for which a prior approval has been obtained from the Central Bank, if the capital of the investee company is increased, the bank may participate in the capital increase within the limits that maintain the same percentage of participation previously approved by the Central Bank, without the need for a new approval. Should a bank desire to increase its percentage of participation in such a company, this case will require the approval of the Central Bank and shall be subject to the rules included in this circular. It has to be noted that such cases leading to the excess of the

(1) This item was amended pursuant to circular No. (2/IBS/219/2008) issued on 13/5/2008.

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value of participation beyond the maximum limit established as the total ratio to the securities portfolio (50% of the capital in its broad concept), or the single investment limit (10% of the capital in its broad concept), shall require the prior approval of the Central Bank and shall be subject to the regulations of this circular.

- 7- In case of applying for exemption from the maximum limit for a single investment of 10% of the capital in its broad concept, this should not result in exceeding the maximum limit established for credit concentration per one single customer (15% of the capital in its broad concept). In such cases, the Central Bank will not approve the exemption that results in exceeding the two mentioned limits together, except for strong justifications presented by the applicant bank to this effect.

**Other factors taken into account when considering applications for exemption from the maximum limits established for financial investments:**

- 1- The extent of the applicant bank's compliance with the laws and regulatory instructions issued by the Central Bank, and the absence of any breaches that have a tangible negative impact or are of a recurrent nature, especially in the area of financial investment.
- 2- Relevant to the previous item is that the Central Bank of Kuwait will impose financial penalties on the bank for breaching the regulations and the limits established under its instructions, as well as the frequency of applying such penalties.
- 3- The evaluation of the overall position of the bank comprising all of its elements, as assessed through evaluating its performance according to CAMEL Approach.
- 4- The extent to which the requested investment serves the purposes of the bank.
- 5- The investment should be of a national or strategic nature, economically or socially. Another relevant point is that the bank has not previously entered into this type of investment which meets one of its purposes, whether in terms of business expansion, profitability or other purposes.
- 6- Any other relevant considerations deemed appropriate by the Central Bank, other than the above considerations.

With my best wishes,

**SALEM ABDUL AZIZ AL-SABAH**

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**GOVERNOR**

*Jumada Al-Aula 8, 1429 H  
May 13, 2008*

**THE CHAIRMAN,**

**Circular to all local Islamic Banks  
(2/IBS/219/2008)**

This has reference to the contents of Central Bank of Kuwait's circular dated 22/3/2006 on the guidelines to be taken into consideration while studying banks' requests for exemption from the prescribed maximum limits of financial investments.

We would like to advise you that it has been resolved to amend Clause (Second/5) of the above circular to read as follows:

**“As for participations in subsidiaries, for which approvals were previously obtained from Central Bank of Kuwait, the bank shall, if willing to increase its stake in these companies, submit a new application to Central Bank of Kuwait to obtain its approval of such increase prior to entering into the new stakes. The application shall be accompanied by reasons justifying the request for such increase.”**

With my best wishes,

**SALEM ABDUL AZIZ AL-SABAH**

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- C) Circular No. (2/IBS/219/2008) Concerning the guidelines to be taken into consideration while studying banks' requests for exemption from the prescribed maximum limits of financial investments.