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PART A OVERVIEW

1. Introduction

- 1.1. The capital adequacy framework (also known as the Risk-Weighted Capital Adequacy Framework) sets out the approach for the computation of minimum capital required by a banking institution in order to operate as a going concern entity. The framework comprises three broad categories, namely the general capital adequacy requirements, components of eligible regulatory capital and the Risk-Weighted Assets (RWA).
- 1.2. The framework, which was introduced in 1989, is developed based on the international standards on capital adequacy introduced by the Basel Committee on Banking Supervision (BCBS) in 1988 (known as Basel I). The international standards which initially covered only credit risk was extended to cover market risk in the trading book in 1996¹.
- 1.3. Prior to the adoption of the framework, the assessment of a banking institution's capital adequacy was undertaken through mechanisms such as free capital ratios, gearing ratios and risk assets ratios. With the introduction of this framework, supervisors and banking institutions had a common method to undertake the capital adequacy assessment.
- 1.4. In June 2004, the BCBS issued a revised international standards on capital adequacy (known as Basel II). In Malaysia, Basel II will be implemented in two stages, that is 2008 for the Standardised Approaches and 2010 for the Internal Ratings Based Approach.
- 1.5. This document sets out the general capital adequacy requirements and the components of eligible regulatory capital. It should be read together with the documents that details out the requirements for computing the RWA as follows:

¹ The framework on assessment of capital in relation to market risks was subsequently introduced in Malaysia in 2004.

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- i) Risk-Weighted Capital Adequacy Framework (Basel I)², which is applicable currently; and
- ii) Risk-Weighted Capital Adequacy Framework (Basel II)³, which is applicable for banking institutions adopting the revised approaches according to the stipulated timelines.

2. Scope

2.1 The framework is applicable to all banking institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA). These institutions will hereafter be referred to as 'banking institutions'.

3. Legal provisions

3.1. The framework is issued pursuant to Section 37 of BAFIA.

2 Based on the 1988 Basel Capital Accord, "International Convergence of Capital Measurement and Capital Standards" issued by the BCBS in July 1988 and subsequent revisions to the Standards (including the requirements on capital assessment in relations to market risk).

3 Based on the Basel II document, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" issued by the BCBS in June 2006 and the Capital Adequacy Standards, "Capital Adequacy Standard for Institutions Other than Insurance Institutions Offering only Islamic Financial Services" issued by the Islamic Financial Services Board in December 2005.

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PART B THE FRAMEWORK

4. Application and general treatment

4.1. Banking institutions are required to comply with the Risk-Weighted Capital Ratio (RWCR) requirement at all times at the following levels:

- i) Entity, referring to the Malaysian operations of a banking institution;
- ii) Global, which includes banking institutions' exposures in local and overseas branch operations, as well as Labuan banking subsidiaries⁴; and
- iii) Consolidated basis, banking institutions are required to include entities covered under the their entity-level requirement plus other local and overseas financial⁵ subsidiaries. In the case of a foreign banking institution, the Malaysian operations of the banking institution will be consolidated with its subsidiaries in Malaysia, provided the investments in the subsidiaries are held in the books of its branch in Malaysia.

⁴ In which an explicit guarantee against liabilities has been provided.

⁵ Financial entities would include banking institutions including Islamic banks licensed under the Islamic Banking Act 1983, securities or stock-broking firms, fund management companies, asset management companies, leasing and factoring companies and any other entities which conduct similar business. However, insurance companies will specifically be excluded. Investments in insurance companies shall be deducted from capital base.

4.2. The general treatment on equity investment at entity and consolidated level is given as follows:

Type of Investment		Treatment	
		At entity level	At consolidated level
Banking	Subsidiaries	Deduction from capital base	Consolidated ⁱ
	Associates	Deduction from capital base	Consolidated ⁱⁱ
	Others	Deduction from capital base ⁶ or investment in the trading book	
Insurance Companies	Subsidiaries	Deduction from capital base	
	Associates /Others	As investment in either the trading or banking book.	
Other Financial ⁷ Entities	Subsidiaries	Deduction from capital base	Consolidated ⁱⁱⁱ
	Associates/Others	As investment in either the trading or banking book.	
Other Commercial Entities	Subsidiaries [#]	Deduction from capital base	
	Associates/Others	As investment in either the trading or banking book.	

ⁱ Where consolidation is not possible, banking institutions are required to deduct the investment in subsidiaries from the capital base.

ⁱⁱ Pro-rata consolidation.

ⁱⁱⁱ Subjected to consolidated supervision framework to be issued by the Bank.

5. Capital adequacy requirements

5.1. The calculation of the RWCR differs, depending on the requirements of Basel I or Basel II.

5.2. The RWCR requirement based on Basel I⁸:

5.2.1. Banking institutions are required to maintain a minimum RWCR⁹ of 8% at all times at the entity, global and consolidated level.

⁶ If the investment is more than 5% of the investee's paid-up ordinary share capital but not yet considered as associates.

⁷ Financial entities would include securities or stock-broking firms, fund management companies, asset management companies, leasing and factoring companies and any other entities which conduct similar business. However, insurance companies will be specifically excluded.

⁸ Applicable currently.

⁹ The RWCR requirement on Islamic banking window is prescribed in the "Guidelines on *Skim Perbankan Islam*".

5.2.2. RWCR for banking institutions:

<p>Capital Base</p> $\text{RWCR} = \frac{\text{Capital Base}}{\text{Credit Risk-Weighted Asset (RWA) + Large Exposure Risk RWA for Equity Holdings* + Market RWA}}$ <p>* Large Exposure Risk RWA for Equity Holdings is as specified in the Bank's "Guidelines on Investment in Shares and Interest in Shares" ** For Investment Banks, the Credit Risk RWA shall include Counterparty Risk RWA and Large Exposure Risk RWA for single counterparty</p>
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5.3. The RWCR requirement based on Basel II¹⁰:

5.3.1. Requirements as per paragraph 5.2.1 shall apply. In addition, for banking institutions with Islamic banking operations, the minimum RWCR of 8% has to be complied at the conventional, Islamic banking operations and overall (conventional plus Islamic banking operations) level.

5.3.2. The calculation of the Risk-Weighted Capital Ratio (RWCR) is derived as follows:

<p>Capital Base</p> $\text{RWCR} = \frac{\text{Capital Base}}{\text{Credit Risk-Weighted Asset (RWA) + Large Exposure Risk RWA for Equity Holdings* + Market RWA + Operational RWA}}$ <p>* Large Exposure Risk RWA for Equity Holdings is as specified in the Bank's "Guidelines on Investment in Shares and Interest in Shares" ** For Investment Banks, the Credit RWA shall include Counterparty Risk RWA and Large Exposure Risk RWA for single counterparty</p>

5.3.3. For banking institutions with Islamic banking operations, the RWCR shall be derived as follows:

¹⁰ Applicable on banking institutions adopting the revised approaches according to the stipulated timelines.

$$\begin{aligned}
 \text{RWCR}_{\text{Conventional}} &= \frac{\text{Capital Base}_{\text{Conventional}}}{\text{Total Risk-Weighted Assets}_{\text{Conventional}}} \\
 \text{RWCR}_{\text{Islamic}} &= \frac{\text{Capital Base}_{\text{Islamic}}}{\text{Total Risk-Weighted Assets}_{\text{Islamic}}} \\
 \text{RWCR}_{\text{Overall}} &= \frac{\text{Capital Base}_{\text{Overall}}}{\text{Total Risk-Weighted Assets}_{\text{Conventional}} + \text{Total Risk-Weighted Assets}_{\text{Islamic}}}
 \end{aligned}$$

5.3.4. For banking institutions with an Islamic banking subsidiary (IS), the consolidated RWCR shall incorporate the IS RWA which will be computed based on a separate guideline for IS to be issued by the Bank at a later date.

5.3.5. For banking institutions with an Islamic banking operations, *Mud rabah*-based deposit funds placed by customers, which are also known as profit-sharing investment accounts (PSIA) in the form of either the General Investment Accounts (GIA) or Specific Investment Accounts (SIA) may be eligible for recognition as an absorbent for credit risk and market risk inherent in the assets funded by the PSIA. The type and quantum of PSIA that can be recognised as a risk absorbent for purposes of the RWCR computation of a banking institution would be subject to the Bank’s specific approval on minimum requirements¹¹ consistent with the following principles:

- i) The ability of the banking institution to tag the PSIA funds

¹¹ The minimum requirements for the recognition of PSIA as a risk absorbent and alpha (α) will be provided in a separate guideline. Alpha (α) represents the proportion of losses from credit and market risk exposures borne by the banking institution, as a result of displaced commercial risk arising from income smoothing practices for PSIA holders. Alpha (α) is expressed as a specified percentage of assets funded by PSIA.

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against its utilisation;

- ii) Adequate risk management capabilities to safeguard PSIA-funded assets;
- iii) The ability to conduct analysis on displaced commercial risk¹² based on empirical evidence, which should include the following:
 - a. Historical analysis on the usage of profit equalisation reserves (PER) and banking institution's profit portion to match the benchmark/market rates on PSIA/other types of deposits; and
 - b. Historical analysis on the gap between return on PSIA-funded assets versus the benchmark/market rates.
- iv) Adequate product transparency and disclosure to investors/depositors on risk and return on PSIA.

5.3.6. PSIA cannot be used as a risk absorbent for operational risk.

¹² Displaced commercial risk is defined as the risk arising from PSIA-funded assets that is transferred to banking institution's capital due to income smoothing practice.

5.3.7. Where PSIA placements are recognised as risk absorbents, the RWCR of the Islamic banking operations will be computed as follows:

RWCR _{Islamic} =	$\frac{\text{Capital Base}_{\text{Islamic}}}{\text{Total Risk-Weighted Assets}^{\text{i}}_{\text{Islamic}}}$
	<p>Less</p> <p>(1-α)ⁱⁱ (Credit and Market Risk-Weighted Assets funded by PSIAⁱⁱⁱ)</p>
	<p>Less</p> <p>(α) (Credit and Market Risk-Weighted Assets funded by PER of PSIA)</p>
	<p>ⁱ Total risk-weighted assets is the sum of credit, market and operational risk-weighted assets of Islamic banking operations</p> <p>ⁱⁱ (1-α) represents the quantum of PSIA that is recognised as risk absorbent for RWCR computation purposes and approved by the Bank.</p> <p>ⁱⁱⁱ PSIA balances include its PER.</p>

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PART C CAPITAL BASE

6. Introduction

- 6.1. Capital represent resources which can be used to meet current losses while leaving banking institutions with the ability to continue operating as a going concern. While equity and disclosed reserves are the main components of capital for banking institutions, there are other legitimate constituents of capital which may be included for purposes of the capital base computation.
- 6.2. The capital base, which is used to compute the RWCR ratio (as well as for use in other regulatory frameworks) is defined as the sum of Eligible Tier 1 Capital and Eligible Tier 2 Capital less any other deductions from total capital.

7. Tier 1 capital (core capital)

- 7.1. Capital instruments that qualify¹³ as Tier 1 Capital should possess the following characteristics:
- i) It should be fully paid-up and permanently available;
 - ii) It should be freely available and not earmarked to particular assets or banking activities;
 - iii) It should be able to absorb losses occurring in the course of on-going business; and
 - iv) It should represent no fixed charge on the earnings of the banking institution.
- 7.2. Items which qualify as Tier 1 capital are as follows:
- i) Ordinary paid-up share capital;
 - ii) Share premium;

¹³ Items that qualify as Tier 1 capital may be subject to certain limits under paragraph 15, after which they are termed as Eligible Tier 1 capital instruments.

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- iii) Statutory reserve fund;
 - iv) General reserve fund;
 - v) Retained profits brought forward from previous financial year as in last audited accounts less any accumulated losses, including current unaudited losses;
 - vi) Surplus after tax arising from the sale of fixed and long-term investments in the course of the banking institution's current financial year;
 - vii) Current unadjusted net profits on a half-yearly basis, subject to certification by the banking institution's approved external auditors;
 - viii) Non-innovative Tier 1 (Non-IT1) capital, subject to prescribed limits;
 - ix) Innovative Tier 1 (IT1) capital, subject to prescribed limits; and
 - x) Minority interests, consistent with the above Tier 1 share capital characteristics, arising from consolidation of less than wholly-owned subsidiaries may be included in the consolidated capital to the extent that such minority interests are readily available to other group entities.
- Positive goodwill (including goodwill arising from consolidation and business combinations) shall be deducted from the above items.

7.3. Tier 1 capital shall be defined as follows:

- i) Tier 1 capital = Eligible Tier 1 Capital
[if Deduction from Total Capital¹⁴ is less than Eligible Tier 2 Capital¹⁵]; otherwise
- ii) Tier 1 capital = Capital Base
[if Deduction from Total Capital is more than Eligible Tier 2 capital. In this instance, the Tier 1 Capital Ratio (Core Capital Ratio) will be equal to the RWCR]

8. Tier 2 capital (supplementary capital)

8.1. Elements which do not meet all of the Tier 1 capital characteristics

¹⁴ Explained in Chapter 9.
¹⁵ Explained in Chapter 8.

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characteristics but which contribute to the underlying strength of a banking institution would be included in total capital as Tier 2 or supplementary capital, subject to prescribed limits.

8.2. Items that qualify for inclusion as Tier 2 capital are as follows:

- i) Hybrid (debt/equity) capital instruments;
- ii) Subordinated term debt, subject to the prescribed limit;
- iii) Reserves arising from the revaluation of premises, provided it is approved by the Bank, subject to the following conditions:
 - a. Based on excess of forced sale value over net book value, or 50% of the excess of fair market value over net book value, whichever is lower;
 - b. Revaluation is permitted only after a period of 10 years from the date of purchase or from the date of last revaluation, whichever is later; and
 - c. The policy of revaluation is optional but once adopted by an institution, it should be applied consistently. All the banking institution's premises should be revalued at a predetermined regular interval (but not less than 10 years). However, at any point of time when the aggregate fair market value for all the banking institution's premises falls below the total net book value (acquisition cost or revalued amount minus accumulated depreciation, if any) of the premises, an immediate downward revaluation should be made. The Bank should be informed of the downward adjustment as soon as possible;
- iv) General provisions¹⁶;
- v) Any Non-IT1 and IT1 capital instruments in excess of the 35% and 15% limits described in Chapter 11; and
- vi) Minority interests, consistent with the above Tier 2 capital characteristics, arising from consolidation of preference shares issued by the banking institution's subsidiaries may be included in the consolidated capital to the extent that such minority interests are

¹⁶ As prescribed under BNM/GP3 Guidelines on Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts dated 23 September 1998.

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readily available to other group entities. The preference shares issued should satisfy the requirements in paragraph 14.3.

Items that qualify as Tier 2 capital may be subject to certain limits described in Chapter 11, after which they are termed as Eligible Tier 2 capital instruments.

9. Deductions from total capital

9.1. For the purpose of calculating the capital base, the following deductions should be made from total capital (first from Tier 2 capital, followed by Tier 1 capital for investments in excess of Tier 2 capital):

- i) Investment in unconsolidated subsidiaries¹⁷ to prevent the multiple use of the same capital resources in different parts of the group;
- ii) Any significant¹⁸ minority interests in banking and other financial entities, where control does not exist shall be deducted from the banking group's capital base;
- iii) Holdings of capital instruments of other banking institutions.^{19,20} Nevertheless, to facilitate trading and provide liquidity for such instruments, certain exemptions are provided as described in paragraph 9.2²¹; and
- iv) Any equity tranches of asset backed securities (ABS).

9.2. Holdings of other banking institution's capital instruments are not subject to deduction from total capital in the following circumstances:

- i) As manager or underwriter for a new issue

¹⁷ Financial and non-financial subsidiaries.

¹⁸ Significant minority interests would be defined as more than 20% and below 50% of the issuer's paid-up capital.

¹⁹ Licensed and supervised by the Bank

²⁰ To discourage double-leveraging of capital which can have systemic dangers for the banking system by making it more vulnerable to the rapid transmission of problems from one institution to another.

²¹ Holdings of shares and interest-in-shares shall still be subject to the relevant provisions in the Banking and Financial Institutions Act 1989 and the circular issued by Bank Negara Malaysia entitled "Guidelines on Investment in Shares and Interest-in-Shares" dated 12 February 2007. Interest-in-shares include any instruments with possibility of being converted into ordinary shares, for example, debt instruments convertible into ordinary shares.

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- Where the banking institution is acting as manager or underwriter for a new issue, the holdings of such securities up to 90 days from the date of issue. The investments, however, shall be subject to the risk weight applied under the Bank's Market Risk Capital Adequacy Framework (MRCAF) and deductions will be made where the investment exceeds 90 days, unless the banking institution also qualifies as a secondary market maker or holds the instruments for trading purposes [see (ii) below];
- ii) As secondary market maker or for trading purposes
- Where the holdings of other banking institutions' capital instruments are primarily for the purpose of trading or market making, capital requirements under the MRCAF shall be applied. However, capital instruments that no longer qualify to be in the trading book and have been transferred to the banking book would be subject to a 100% risk weight²², except for holdings of shares and interest-in-shares where deduction from capital base shall be applied.
 - Holdings within the following limits shall not be deducted from capital base (non-deduction rule):
 - a. Not exceeding 15% of the investor's or 10% of the investee's capital base, whichever is lower;
 - b. In addition to (a) above for shares and interest-in-shares, not exceeding 5% of the investee's paid-up ordinary share capital;
 - c. Total holdings of other banking institution's capital instruments shall not exceed 25% of the investor's capital base at all times. Amounts in excess of the above limits shall be deducted from capital base. Illustration for the calculation of the non-deduction rule is given in **Appendix 1**.
 - In the case of holdings of bonds where the underlying assets comprise of banking institution's capital instruments, the non-

²² The Bank reserves the right to require the exposure to be risk-weighted at 150% if deemed as high risk.

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deduction rule would apply if the following conditions are met:

- a. Bond holdings per issuer should not exceed 10% of the individual issue size or 10% of the investor's capital base, whichever is lower;
- b. Total bond holdings (in aggregate) should not exceed 10% of the investor's capital base at all times; and
- c. The bonds must be rated at least BBB.

10. Exclusions

10.1. Deferred tax income or (expense) shall be excluded²³ from the computation of the capital base of banking institutions.

11. Limits

11.1. Capital instruments are recognized for purposes of calculating the capital base subject to the following limits:

- i) The total amount of supplementary capital eligible for inclusion shall not exceed the amount of Eligible Tier 1 capital;
- ii) The amount of subordinated term loans eligible for inclusion as Tier 2 capital are limited to 50% of Eligible Tier 1 capital. In exceptional cases, this limit may be exceeded with the prior written consent of the Bank, on a case-by-case basis;
- iii) Total issuance of IT1 capital instruments shall not exceed 15% of total Eligible Tier 1 capital (after the inclusion of the IT1 instruments and net of goodwill). (Refer to **Appendix 2** for illustration);
- iv) A limit of 50% of total Eligible Tier 1 capital (net of goodwill) is imposed on the total of Non-IT1 and IT1 capital instruments, with IT1 capital still limited at 15% of Eligible Tier 1 capital. As such, the composition of Tier 1 capital can be summarized as follows:

²³ Deferred tax assets are also excluded from the calculation of risk-weighted assets.

Tier 1 capital

Retained earnings, reserves, ordinary shares			
Non-Innovative Tier 1 [consisting of qualifying Non-Cumulative Perpetual Preference Shares (NCPPS) only]	}	35%	} 50% (maximum of NCPPS if there is no IT1 instruments)
Innovative Tier 1 (consisting of other types of preference shares, hybrid and debt instruments)	}	15%	

- v) Any amount in excess of the prescribed limit shall be eligible for inclusion as upper Tier 2 capital. Notwithstanding the above limits, the Bank reserves the right to impose a lower limit based on the soundness of the individual issuer; and
- vi) Banking institutions should limit its long-term investments in fixed assets and shares (other than those deducted from total capital, i.e. investments in unconsolidated subsidiaries and holdings of other licensed banking institutions' capital) to not more than 50% of its capital base. The 50% limit is to ensure that banking institutions do not over-invest in assets which yield no specific and reasonably certain returns without a ringgit-for-ringgit capital support.

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PART D SPECIFIC REQUIREMENTS ON CAPITAL INSTRUMENTS

12. Non-Innovative Tier 1 capital instruments (Non-IT1)

12.1. Non-IT1 capital instruments consist only of Non-Cumulative Perpetual Preference Shares (NCPPS) which fulfils the Tier 1 capital instruments requirements as follows:

- i) Fully paid-up and permanently available;
- ii) Be freely available and not earmarked to particular assets or banking activities;
- iii) Be able to absorb losses occurring in the course of the on-going business;
- iv) Should represent no fixed charge on the earnings of the banking institution;
- v) Ranks senior only to ordinary shares on a winding up;
- vi) Redeemable no earlier than its 5th year of anniversary at the option of the issuer, except where the instruments were issued for the purpose of merger or acquisition which is subsequently aborted. Any redemption is subject to the Bank's approval;
- vii) Does not have additional features that:
 - Impose pressure for early redemption, for example step-ups in coupon rates; and
 - Involves structures that are complex and non-transparent, which may raise doubt on its performance as high quality capital in times of distress, for example indirect issuance via a Special Purpose Vehicle (SPV).

12.2. The accounting classification of the NCPPS, either as equity or debt, should not be used as a key criterion for inclusion in Non-IT1 category. However, the issuer shall demonstrate, substantiated by legal opinions, that the Tier 1 characteristics are not compromised even if the instruments are classified as

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a liability.

13. Innovative Tier 1 capital instruments (IT1)

13.1. While there is no common definition of IT1 capital across jurisdictions, it generally covers hybrid capital instruments with the characteristics of both equity (eg. loss absorbing on going concern basis, perpetual) and debt (eg. tax deductible). In Malaysia, IT1 capital is defined to include:

- i) Preference shares that have additional features including moderate step-up rates and limited call provisions; and
- ii) Hybrid instruments not classified as hybrid Tier 2 capital instruments, that meet all the minimum requirements for IT1 capital instruments specified in paragraphs 13.4 and 13.5.

13.2. These instruments may be issued either directly by the banking institution or indirectly through a Special Purpose Vehicle (SPV), with the proceeds being passed to the banking institution via an inter-company loan. Due to its complexity and less transparent nature, indirect issuances are subject to additional requirements as in paragraph 13.5 below.

13.3. Regardless of the approach adopted, it is the responsibility of the issuer to clarify with the Inland Revenue Board on the tax status of such instruments and ensure that they are done in accordance with the tax provisions in Malaysia.

13.4. The IT1 capital instruments (both direct and indirect issuances) shall fulfill the following minimum requirements:

- i) Issued and fully paid-up;
- ii) Permanent;
- iii) Non-cumulative. However, interest/dividends cumulative in the form of stock settlement may be considered on a case-by-case basis²⁴, whereby a maximum limit as deemed appropriate by the Bank may be imposed to avoid unreasonably large accumulation of amount owing

²⁴ Banking institutions must have a strong justification for incorporating the coupon stock settlement feature.

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- on deferred interest/dividends;
- iv) Able to absorb losses on a going-concern basis. For IT1 capital instruments classified as debt, this could be achieved by either:
 - Full disclosure of nature of loss absorption in the agreement governing the issuance of the capital instruments indicating the fulfillment of this condition (write down of instruments); or
 - Mandatory conversion from debt to equity upon the occurrence of the following minimum trigger events:
 - a. Breach of minimum 8% Risk-Weighted Capital Ratio;
 - b. Commencement of proceedings for winding up of the banking institution; or
 - c. Upon appointment of administrator for the banking institution.
 - v) The rate of conversion must be fixed at the time of issuance and the banking institution shall maintain a sufficient margin of unissued authorised share capital, for conversion to take place at any time. For indirect issuances, this would involve conversion into equity issued by the banking institution;
 - vi) Senior only to all equity shareholders;
 - vii) Neither secured nor covered by a guarantee of the banking institution or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis banking institutions' creditors;
 - viii) Callable at the initiative of the issuer after 5 years from the issue date subject to regulatory approval. Earlier redemption (less than 5 years) is allowed only in the following cases:
 - The IT1 capital was issued for the purpose of merger and acquisition (M&A) but the M&A was subsequently aborted or unsuccessful; or
 - There was a change in the tax status of the IT1 capital instruments due to changes in tax laws, provided there is reasonable capital buffer after the banking institution is subjected to stress testing by the Bank.
 - ix) Proceeds should be immediately available to the banking institution

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without any limitation;

- x) There is no provision in the agreement governing the issuance of IT1 capital instruments which may cause an early redemption such as restrictive covenants, cross-default or negative pledge clauses. However, a moderate step-up is permitted with a call option subject to the following:
- xi) Only one rate step-up is allowed over the life of the instrument;
 - The step-up occurs no earlier than 10 years after the issue date; and
 - The stepped-up rate over the initial rate is no greater than 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis (if there is a change in the index basis) or a higher rate as deemed appropriate by the Bank²⁵. Swap spread is fixed as at the pricing date and reflect the differential in pricing on that date between the initial reference security rate and the stepped-up reference security rate. (See **Appendix 3** for illustration):
- xii) Banking institution has full discretion over the amount and timing of interest/dividend payments except where interest/dividends are paid on any obligations that are ranked junior to the IT1 capital instruments. In addition, banking institution must have full control and access to waived payments including dividends waived by the SPV in the indirect structure;
- xiii) Payments can only be paid out of distributable items. Interest/dividend rate (including step-up rate) shall be preset at the time of issuance of the IT1 capital and shall not be reset based on the credit standing of the banking institution;
- xiv) Adequate disclosure and explanation of the features of IT1 capital instruments; and
- xv) Amendments to the terms and conditions governing the issuance of

²⁵ This shall be within the 50% of the initial credit spread as recommended by the Basel Committee on Banking Supervision.

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IT1 capital instruments shall only be made with the prior approval of the Bank.

13.5. Indirect issuances of IT1 capital instruments shall also fulfill the following additional requirements to be eligible as Tier 1 Capital at the solo consolidated level:

- i) SPV is domiciled in Labuan;
- ii) SPV is wholly-owned and managed by the banking institution;
- iii) SPV is set up for the purpose of capital issuance for the banking institution and does not conduct any other business or activity;
- iv) SPV has no external creditors at any time;
- v) The entire proceeds from the capital issuance via SPV shall be on-lent (via inter-company loan) to the banking institution without any restrictions; and
- vi) The inter-company loan shall be:
 - vii) Permanent;
 - viii) Consistent with the terms and conditions of the preference shares issued by the SPV;
 - ix) Senior only to all equity holders; and
 - x) Able to absorb losses of the banking institution on a going-concern basis.
- xi) In addition,
 - The agreement governing the issuance of the inter-company loan does not contain any provisions that could trigger an acceleration of repayments; and
 - Amendments to the agreement governing the inter-company loan shall only be made with the prior approval of the Bank.

13.6. Banking institutions are required to confirm to the Bank that it has received third party legal and accounting opinions on the fulfillment of the minimum requirements for IT1 capital instruments as well as the tax treatment of these capital instruments.

13.7. With respect to the issuance of IT1 capital instruments, the Minister of Finance has accorded the following tax treatment for the computation of

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income tax by the issuer (subject to having obtained written approval from the Bank for issuance of such instruments):

- i) Coupon or interest payment to investors of the IT1 capital instruments shall be regarded as deductible expense;
- ii) Coupon or interest payment to the Special Purpose Vehicle Labuan (SPV) for the inter-company loan between the SPV and the licensed financial institution, shall be regarded as deductible expense; and
- iii) Pursuant to Section 2(1)(f) of the Labuan Offshore Business Activity Tax Act 1990, the onward lending in Malaysian currency of the proceeds from the issuance of IT1 capital instruments by the SPV to the licensed financial institution shall be regarded as an offshore business activity, subject to the following conditions:
 - The SPV issuing the IT1 capital instruments approved by the Bank only has transactions with Malaysian licensed banking institutions; and
 - The SPV maintains records and documents with regards to the issuance of the IT1 capital instruments and allows the Inland Revenue Board to conduct tax audit to verify profit and provide transparency of activities conducted.

14. Hybrid Tier 2 capital instruments

14.1. Subject to the approval of the Bank, on a case-by-case basis, hybrid (debt/equity) capital instruments, such as cumulative preference shares, perpetual loan stocks and mandatory convertible loan stocks.

14.2. The hybrid capital instruments should have close similarities to equity; in particular, they must be able to support losses on an on-going basis without triggering liquidation. Hybrid capital instruments which do not meet fully the above criteria may be eligible for inclusion under the category of subordinated term debt. The Bank will only approve the issue of irredeemable convertible unsecured loan stocks with maturity not exceeding 5 years.

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14.3. Hybrid Tier 2 capital instruments (and minority interests arising from the consolidation of preference shares issued by subsidiaries of banking institutions) should satisfy the following requirements:

- i) Unsecured, subordinated and fully paid-up;
- ii) Not redeemable at the initiative of the holder or without prior consent of the Bank;
- iii) Available to participate in losses without the banking institution being obliged to cease trading; and
- iv) Service obligation can be deferred where the profitability of the institution would not support payment.

15. Subordinated debt instruments

15.1. Unlike the hybrid capital instruments, the instruments under this category are not normally available to participate in the losses of a bank which continues trading; they being able to absorb losses only in a liquidation. The items under this category would, subject to the approval of the Bank on a case-by-case basis, include term debt²⁶ and limited life redeemable preference shares which do not fully meet the requirements enumerated in Chapter 14 above, but which satisfy the following conditions:

- i) Unsecured, subordinated and fully paid-up;
- ii) A minimum original fixed term to maturity of five years;
- iii) Early repayment or redemption shall not be made without the prior consent of the Bank;
- iv) The instruments should be subject to straight line amortisation over the last 5 years of their life; and
- v) There should be no restrictive covenants.

²⁶ Includes Exempt Subordinated Debt Capital.

APPENDICES

Appendix 1 Illustration for the Calculation of the Non-Deduction Rule

Scenario 1: Subscription do not exceed aggregate threshold

10% of issuer's capital base (a=10%of RM400m)	15% of subscriber's capital base (b=15% of RM440m)	Individual threshold (c= the lower of a or b)	Aggregate threshold (f=c/adjusted capital base)
40	66	40	14%

Bank X subscribes RM200m of the capital instruments issued by Bank A. Bank A has a capital base of RM400m, while Bank X's capital base is RM440m.

Step 1: Determine the individual threshold [item (c)]

The lower of (a) or (b), which is RM40m.

Step 2: Determine the amount not eligible for non-deduction

RM40m is allowed for non-deduction, while the balance of RM160m should be deducted from Bank X's total capital.

Step 3: Determine the aggregate threshold [item (d)]

The RM40m not deducted represents 14% of Bank X's capital base of RM280m after deducting RM160m (ie. RM440m – RM160m = RM280m).

Scenario 2: Subscription exceeds aggregate threshold

Bank X subscribes RM200m of the capital instruments issued by Bank A. Bank A has a capital base of RM400m, while Bank X's capital

10% of issuer's capital base (a=10%RM400m)	15% of investor's capital base (b= 15%RM440m)	Individual threshold (c= the lower of a or b)	Amount eligible for non-deduction under individual threshold (d)	Amount eligible for non-deduction under aggregate threshold (e)	Aggregate threshold (f=e/adjusted capital base)
40	66	40	40	65	25%

base is RM440m. In addition, Bank X has an outstanding cumulative amount eligible for non-deduction from previous subscriptions totalling RM50m.

Step 1: Determine the individual threshold [item (c)]

The lower of (a) or (b), which is RM40m.

Step 2: Determine the amount not eligible for non-deduction

Out of the RM40m allowed for non-deduction under the individual threshold, only RM15m is allowed for actual non-deduction. This is because any non-deduction greater than this amount will exceed the aggregate threshold of 25% after incorporating Bank X's current subscriptions of RM50m. The capital base has to be adjusted to reflect the future holdings of Bank A's capital instruments.

Step 3: Determine the amount held as % of total capital [item (f)]

Cumulatively, RM65m is allowed for non deduction (RM50m from Bank X's outstanding subscription and RM15m from Bank A's issuance). This represents 25% of Bank X's capital base (RM260m, adjusted after deduction for holdings of Bank A's issuance).

Appendix 2

Illustration on limit of IT1 capital instruments

Capital structure of a banking institutions:	RM' million	
Reserves	27	
Common equity	40	
Non-cumulative perpetual preference shares (NCPPS)	20	
Minority interest of a consolidated subsidiary	3	
Goodwill	(5)	
Innovative Tier 1 instruments	15	→
Total Tier 1	<u>100</u>	15/100 = 15%

In other words, the amount allowable as IT1 is the amount of Tier 1 capital (before the inclusion of IT1 capital, and net of goodwill) multiplied by 17.65% (whereby 17.65% = 15%/85%). As per the example above, it is RM85m x 17.65% = RM15m.

Appendix 3

Illustration for determining the swap spread

1. Determining the swap spread:

INITIAL

Index basis (10-year MGS*)	5.0%*
Credit spread	2.0%
Coupon rate	<u>7.0%</u>

STEPPED-UP

Index basis (10-year MYR swap rate)	5.5%
Adjusted credit spread to achieve initial rate of 7.0%	1.5%
Coupon rate	<u>7.0%</u>

Swap spread of 0.5%

2. Calculating new coupon rate (Stepped-up)

Index basis (10-year MYR swap rate)	5.5%
Initial Credit spread	2.0%
	<u>7.5%</u>
Step-up (100 b.p)	1.0%
	<u>8.5%</u>
Less: Swap spread	<u>(0.5%)</u>
Stepped-up coupon rate	<u>8.0%</u>

* Index basis and figures used are for illustration purposes only