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PART A OVERVIEW

1. Introduction

- 1.1. The capital adequacy frameworks which comprise of the Risk-Weighted Capital Adequacy Framework (applicable to commercial and investment banking institutions) and the Capital Adequacy Framework for Islamic Banks set out the approach for the computation of minimum capital required by a banking institution in order to operate as a going concern entity. Both frameworks comprise three broad categories, namely the general capital adequacy requirements, components of eligible regulatory capital and the Risk-weighted Assets (RWA).
- 1.2. The Risk-Weighted Capital Adequacy 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. In June 2004, the BCBS issued revised international standards on capital adequacy (known as Basel II). In Malaysia, Basel II is implemented in two stages, that is 2008 for the Standardised Approaches and 2010 for the Internal Ratings-Based (IRB) Approach.
- 1.4. The Capital Adequacy Framework for Islamic Banks, which was implemented on 1 January 2008, is developed based on the Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services issued by the Islamic Financial Services Board in December 2005.

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

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- 1.5. This document sets out the general capital adequacy requirements and the components of eligible regulatory capital². It should be read together with the documents that detail the requirements for computing the RWA as follows:
- i) Risk-Weighted Capital Adequacy Framework (Basel II – Risk-Weighted Assets Computation)³, which is applicable for banking institutions adopting the revised approaches according to the stipulated timelines;
 - ii) Risk-Weighted Capital Adequacy Framework (Basel I – Risk-Weighted Assets Computation)⁴, which is applicable for banking institutions which have been given approval to migrate directly to the IRB approach in 2010; and
 - iii) Capital Adequacy Framework for Islamic Banks, which is applicable for Islamic banks licensed under Section 3 (4) of the Islamic Banking Act 1983 (IBA).

2. Scope

- 2.1. The framework is applicable to all banking institutions licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and all Islamic banks licensed under Section 3 (4) of the IBA. These institutions will hereafter be referred to as 'banking institutions'.

² For Islamic banks and banking institutions licensed under BAFIA with Islamic banking operations, the implementation of this framework shall be subject to compliance with Shariah principles and requirements.

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.

⁴ 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).

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3. Legal Provisions

3.1. The framework is issued pursuant to Section 37 of BAFIA and Section 53A of IBA.

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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 level, referring to the Malaysian operations of a banking institution;
- ii) Global level, which includes banking institutions' exposures in local and overseas branch operations, as well as Labuan banking subsidiaries⁵; and
- iii) Consolidated level, which includes entities covered under the global level requirement plus other financial⁶ subsidiaries. In the case of a locally-incorporated foreign banking institution, the Malaysian operations of the banking institution will be consolidated with its subsidiaries, provided the investments in the subsidiaries are held in the books of its operations in Malaysia.

⁵ Where an explicit guarantee against liabilities has been provided by the banking institution.

⁶ Financial entities would include banking institutions, 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 and takaful companies will specifically be excluded. Investments in insurance and takaful companies shall be deducted from capital base.

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

Type of Investment		Treatment	
		At entity level	At consolidated level
Banking institutions	Subsidiaries	Deduction from capital base	Consolidated ⁱ
	Associates ⁷	Deduction from capital base	Consolidated ^{i,ii}
	Others	Deduction from capital base ⁸ or investment in the trading book	
Insurance and takaful companies	Subsidiaries	Deduction from capital base	
	Associates ⁷ /Others	As investment in either the trading or banking book.	
Other financial ⁹ entities	Subsidiaries	Deduction from capital base	Consolidated ⁱ
	Associates ⁷ /Others	As investment in either the trading or banking book.	
Other commercial entities	Subsidiaries	Deduction from capital base	
	Associates ⁷ /Others	As investment in either the trading or banking book.	
ⁱ Where consolidation is not possible, banking institutions are required to deduct the investment from the capital base. ⁱⁱ Pro-rata consolidation.			

4.3 Any exposures which have been deducted from capital base shall not be subject to any further capital charges when computing the RWCR.

5. Capital Adequacy Requirements

5.1. All banking institutions are required to maintain a minimum RWCR¹⁰ of 8% at all times at the entity, global and consolidated levels.

⁷ Defined as more than 20% and below 50% of the issuer's paid-up ordinary share capital.

⁸ If the investment is more than 5% of the investee's paid-up ordinary share capital but not yet considered as associates.

⁹ 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 and takaful companies will be specifically excluded.

¹⁰ The RWCR requirement on Islamic banking operations of banking institutions licensed under BAFIA is prescribed in the "Guidelines on *Skim Perbankan Islam*".

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5.2. The RWCR computation under Basel I is determined as follows:

$\text{RWCR} = \frac{\text{Capital Base}}{\text{Credit Risk-weighted Asset (RWA)}^i + \text{Large Exposure Risk RWA for Equity Holdings}^{ii} + \text{Market RWA}}$ <p>ⁱ For Investment Banks, the Credit RWA shall include Counterparty Risk RWA and Large Exposure Risk RWA for a single counterparty</p> <p>ⁱⁱ Large Exposure Risk RWA for Equity Holdings is as specified in the Bank's Guidelines on "Risk-weighted Capital Adequacy Framework (Basel I – Risk-weighted Assets Computation)".</p>
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5.3. The RWCR computation under Basel II is determined as follows:

$\text{RWCR} = \frac{\text{Capital Base}}{\text{Credit RWA}^i + \text{Large Exposure Risk RWA for Equity Holdings}^{ii} + \text{Market RWA} + \text{Operational RWA}}$ <p>ⁱ For Investment Banks, the Credit RWA shall include Counterparty Risk RWA and Large Exposure Risk RWA for a single counterparty</p> <p>ⁱⁱ Large Exposure Risk RWA for Equity Holdings is as specified in the Bank's Guidelines on "Risk-weighted Capital Adequacy Framework (Basel II – Risk-weighted Assets Computation)" and "Capital Adequacy Framework for Islamic Banks".</p>

5.3.1. For banking institutions licensed under BAFIA with Islamic banking operations, the minimum RWCR of 8% has to be complied with at the conventional banking, Islamic banking and overall (conventional plus Islamic banking) entity level. The RWCR shall be derived as follows:

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

5.3.2. The profit-sharing investment account (PSIA) deposit funds placed by customers may be eligible for recognition as a risk absorbent¹¹ for credit risk and market risk inherent in the assets funded by the PSIA. However, the PSIA cannot be used as a risk absorbent for operational risk that is solely borne by the Islamic bank.

¹¹ PSIA is a deposit accepted by a banking institution based on the *Mudharabah* contract, where PSIA holders and the banking institution agree to share in the profits generated from the assets funded by the PSIA fund at an agreed profit sharing ratio. However, any losses will be fully borne by the PSIA holders.

5.3.3. Where Islamic banks or banking institutions licensed under BAFIA with Islamic banking operations are able to satisfy the requirements stipulated under the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent, the RWCR shall be derived as follows:

$$\begin{aligned}
 \text{RWCR}_{\text{Islamic}} = & \frac{\text{Capital Base}_{\text{Islamic}}}{\text{Total Risk-weighted Assets}^{\text{i}}_{\text{Islamic}}} \\
 & \text{Less} \\
 & (1-\alpha)^{\text{ii}} \text{ (Credit and Market Risk-weighted Assets funded by PSIA}^{\text{iii}}) \\
 & \text{Less} \\
 & (\alpha) \text{ (Credit and Market Risk-weighted Assets funded by PER of PSIA)}
 \end{aligned}$$

ⁱ Total RWA is the sum of Credit, Market, Operational RWA and Large Exposure Risk RWA for Equity Holdings.

ⁱⁱ $(1-\alpha)$ represents the quantum of PSIA that is recognised as risk absorbent for RWCR computation purposes.

ⁱⁱⁱ PSIA balances include Profit Equalisation Reserves.

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PART C CAPITAL BASE

6. Introduction

- 6.1. Capital represents resources which can be used to meet current and foreseeable future 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 (as well as for the purpose of other regulatory limits) is defined as the sum of Eligible Tier 1 and Eligible Tier 2 Capital as defined under paragraphs 7.3 and 8.3 respectively.

7. Tier 1 Capital (Core Capital)

- 7.1. Items and capital instruments that qualify as Tier 1 Capital shall have the following characteristics:
- i) Fully paid-up and permanently available;
 - ii) Freely available and not earmarked to particular assets or banking activities;
 - iii) Able to absorb losses occurring in the course of on-going business; and
 - iv) Do not represent any fixed charge on the earnings of the banking institution.
- 7.2. Based on paragraph 7.1, the following items and capital instruments¹² qualify as Tier 1 capital:
- i) Ordinary paid-up share capital;
 - ii) Share premium;
 - iii) Statutory reserve fund;
 - iv) General reserve fund;

¹² Excluding holdings of banking institutions' own Tier 1 capital instruments.

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- v) Capital redemption reserve fund;
- vi) Retained profits brought forward from the previous financial year less current unaudited losses and retained losses from the prior financial year yet to be recognised;
- vii) Surplus after tax arising from the sale of fixed and long term investments during the current financial year;
- viii) Current unadjusted half-yearly net profits, subject to certification by the banking institution's approved external auditors;
- ix) Non-innovative Tier 1 (Non-IT1) capital, subject to prescribed limits;
- x) Innovative Tier 1 (IT1) capital, subject to prescribed limits; and
- xi) For RWCR computation at the consolidated level only, minority interests which meet the above Tier 1 capital characteristics.

7.3. Eligible Tier 1 capital shall consist of the Tier 1 capital items prescribed in paragraph 7.2, subject to deductions and limits as described in Sections 9 and 11.

8. Tier 2 Capital (Supplementary Capital)

8.1. Items or capital instruments which do not meet all of the Tier 1 capital 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. The following items or capital instruments¹³ qualify for inclusion as Tier 2 capital:

- i) Hybrid (debt/equity) capital instruments;
- ii) Subordinated term debt/ sukuk, subject to the prescribed limit;
- iii) Reserves arising from the revaluation of premises¹⁴, provided it is approved by the Bank and 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; and

¹³ Excluding holdings of banking institutions' own Tier 2 capital instruments.

¹⁴ As per Financial Reporting Standard 116 (Property, Plant and Equipment).

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b. Banking institutions can only recognise revaluation surpluses on premises after a period of 10 years from the date of purchase or from the date of last revaluation, whichever is later. The need to establish a revaluation policy on premises is optional but once adopted, should be applied consistently. Generally, the Bank expects banking institutions to revalue their premises regularly at predefined intervals.

- iv) General provisions¹⁵;
- v) Any Non-IT1 and IT1 capital instruments in excess of the limits described in paragraph 11.1;
- vi) Surplus eligible provisions over expected losses, subject to a maximum of 0.6% of the credit risk-weighted asset determined under the IRB approach; and
- vii) For RWCR computation at the consolidated level only, minority interests which meet the description in paragraph 8.1.

8.3. Eligible Tier 2 capital shall consist of Tier 2 capital items prescribed in paragraph 8.2, subject to deductions and limits as described in Sections 9 and 11.

9. Deductions

9.1. For the purpose of calculating capital base, the following deductions should be made :

9.1.1. From Tier 1 capital

- i) Positive goodwill (including goodwill arising from consolidation and business combinations); and
- ii) Any capital deductions in excess of Tier 2 capital as specified in paragraph 9.1.3.

9.1.2. From Tier 2 capital

- i) Holdings of capital instruments of other banking institutions^{16,17}

¹⁵ As prescribed under BNM/GP3 “Guidelines on Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts”. This is not applicable for banking institutions which have implemented the IRB approach for credit risk.

¹⁶ Licensed and supervised by the Bank.

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(including investments in banking subsidiaries which are not consolidated). Nevertheless, to facilitate trading and provide liquidity for such instruments, certain exemptions are provided as described in paragraph 9.2;

- ii) Interests in other (non-banking) subsidiaries which are not consolidated;
- iii) Any deductions for securitisation exposures;
- iv) Any deficit in provisions for expected losses as determined under the IRB approach; and
- v) Expected losses for equity exposures derived under the PD/ LGD approach for banking institutions under the IRB approach.

9.1.3. In the event that the amount to be deducted from Tier 2 Capital (as per paragraph 9.1.2 above) exceeds the Tier 2 Capital amount, the excess amount shall be deducted from Tier 1 capital.

9.2. Holdings of other banking institutions' capital instruments are not subject to the deduction from capital (non-deduction rule) in the following circumstances:

9.2.1. Where the banking institution is acting as manager or underwriter for a new issue:

- i) Any holdings of such securities up to 90 days from the date of issue. The investment shall however be subject to the risk weight applied under the market risk component of the Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks.
- ii) Deductions will be made when the investment exceeds 90 days, unless the banking institution also qualifies as a secondary market maker or holds the instruments for trading purposes (see paragraph 9.2.2 below).

¹⁷ To discourage double-leveraging of capital which can render the banking system more vulnerable to the rapid transmission of problems from one institution to another.

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9.2.2. Where the banking institution is acting as secondary market maker or holds the instruments for trading purposes:

- i) Holdings (including shares and interest-in-shares) not exceeding 15% of the investing banking institution's or 10% of the investee's capital base, whichever is lower;
- ii) Notwithstanding (i) above, for shares and interest-in-shares, holdings not exceeding 5% of the investee's paid-up ordinary share capital;
- iii) The above is subject to total holdings of other banking institution's capital instruments not exceeding 25% of the investing banking institution's capital base.

An illustration of the above calculations is given in **Appendix I**.

- iv) For holdings of bonds where the underlying assets comprise of other banking institution's capital instruments, the non-deduction rule will apply subject to :
 - a. The bond holdings per issuer not exceeding 10% of the individual issue size or 10% of the investing banking institution's capital base, whichever is lower;
 - b. Total bond holdings (in aggregate) not exceeding 10% of the investing banking institution's capital base; and
 - c. The bonds must be rated at least BBB.

9.2.3. The holdings of capital instruments specified in paragraph 9.2.2 above shall be subject to the capital requirements under the market risk component of the Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks except where the instruments (other than shares and interest-in-shares) no longer qualify to be in the trading book or have been transferred to the banking book, in which case a risk weight of 100%¹⁸ shall apply. Deduction from capital base shall however, be required for holdings of shares and interest-in-shares which have subsequently been transferred from the trading book to the banking book.

¹⁸ The Bank reserves the right to require the exposure to be risk-weighted at 150% if deemed as high risk.

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10. Exclusion

10.1. Deferred tax income or (expense)¹⁹ shall be excluded from the computation of capital base.

11. Limits

11.1. For qualifying capital instruments, the following limits shall apply in the computation of the capital base:

- i) The total amount of Tier 2 capital eligible for inclusion shall not exceed the amount of Tier 1 capital;
- ii) The amount of subordinated term debt/ sukuk eligible for inclusion as Tier 2 capital is limited to 50% of Tier 1 capital. In exceptional cases, this limit may be exceeded with the prior written consent of the Bank;
- iii) Total issuance of IT1 capital instruments shall not exceed 15% of total Tier 1 capital after the inclusion of the IT1 instruments. (Refer to **Appendix II** for illustration);
- iv) In addition to the limit under (iii) above, a limit of 50% of Tier 1 capital is imposed on the total of Non-IT1 and IT1 capital instruments. As such, the composition of Tier 1 capital can be summarised as follows:

¹⁹ Deferred tax assets shall also be excluded from the computation of risk-weighted assets.

Tier 1 capitalⁱ

Retained earnings, reserves, ordinary shares								
Non-Innovative Tier 1					}	35%	}	50% (maximum of Non-IT1 instrument if there is no IT1 instrument)
Innovative Tier 1 (Consisting of other types of preference shares, hybrid and debt instruments).								

ⁱ Net of goodwill only.

- v) Any Non-IT1 and IT1 capital instruments in excess of the prescribed limit shall be eligible for inclusion as Tier 2 capital, subject to the limit specified in (i) above.

11.2. Notwithstanding the above limits, the Bank reserves the right to impose a lower limit, where appropriate, to preserve the financial soundness of an individual banking institution based on the Bank's supervisory assessments.

11.3. For the purpose of paragraph 11.1 above, banking institutions shall observe the following:

- i) Tier 1 capital shall be defined as Tier 1 capital (as per paragraph 7.2) net of goodwill only; and
- ii) Tier 2 capital shall be defined as per paragraph 8.2 (before any deductions).

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PART D SPECIFIC REQUIREMENTS ON CAPITAL INSTRUMENTS

12. Non-Innovative Tier 1 (IT1) Capital Instruments

12.1. Items and capital instruments which qualify as Non-IT1 capital shall have the following characteristics:

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

12.2. The accounting classification of an instrument, either as equity or debt, should not be used as a key criterion for inclusion as Non-IT1 capital. 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 Non-IT1 capital instruments and the tax treatment of these capital instruments respectively.

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13. Innovative Tier 1 (IT1) Capital Instruments

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 (e.g. loss absorbing on a going concern basis, perpetual) and debt (e.g. 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 (as per Section 14), 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/ financing. Due to its complexity and less transparent nature, indirect issuances are subject to additional requirements set out in paragraph 13.5 below.

13.3. It is the responsibility of the banking institution to clarify the tax status of such instruments with Lembaga Hasil Dalam Negeri (Inland Revenue Board) and ensure compliance 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, cumulative interest/ profit/ dividends in the form of stock settlement may be considered on a case-by-case basis²⁰, subject to a maximum limit which may be imposed by the Bank to avoid an excessive accumulation of amounts owing on deferred interest/ profit/ dividends;

²⁰ Banking institutions must have a strong justification for incorporating the coupon stock settlement feature.

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- iv) Able to absorb losses on a going-concern basis. For IT1 capital instruments classified as debt, this could be achieved by either:
- a. 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
 - b. Mandatory conversion from debt to equity upon the occurrence of the following minimum trigger events:
 - Breach of the minimum 8% Risk-weighted Capital Ratio;
 - Commencement of proceedings for winding up of the banking institution; or
 - Upon appointment of an administrator for the banking institution.
- v) The rate of conversion must be fixed at the time of issuance and the banking institution shall maintain at all times a sufficient margin of unissued authorised share capital, for the purpose of conversion. For indirect issuances, the conversion shall be into equity issued by the banking institution;
- vi) Rank senior only to all equity shareholders on a winding up;
- vii) Must be neither secured nor covered by a guarantee of the banking institution or related entity or other arrangements that legally or economically enhances the seniority of the claim vis-à-vis banking institutions' creditors;
- viii) Callable at the option of the banking institution no earlier than 5 years from the issue date except where:
- a. The IT1 capital was issued for the purpose of a merger and acquisition which was subsequently aborted; or
 - b. There was a change in the tax status of the IT1 capital instruments due to changes in tax laws.
- Any redemption is subject to the Bank's approval and assurance of a reasonable capital buffer after redemption, including under stress conditions.
- ix) Proceeds should be immediately available to the banking institution without any limitation;

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- 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:
- a. Only one rate step-up is allowed over the life of the instrument;
 - b. The step-up occurs no earlier than 10 years after the issue date; and
 - c. 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 Bank²¹. The swap spread is fixed at the pricing date and reflects the differential in pricing on that date between the initial reference security rate and the stepped-up reference security rate. (See Appendix III for illustration):
- xi) The banking institution has full discretion over the amount and timing of interest/profit/ dividend payments except where interest/profit/ dividends are paid on any obligations that are ranked junior to the IT1 capital instruments. In addition, the banking institution must have full control over and access to waive payments, including any dividends waived by the SPV under an indirect structure;
- xii) Payments can only be made out of distributable items. The interest/profit/ dividend rate (including the 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;
- xiii) Adequate disclosure and explanation of the features of IT1 capital instruments; and
- xiv) Amendments to the terms and conditions governing the issuance of the IT1 capital instruments shall only be made with the prior approval of the Bank.

²¹ This shall be within 50% of the initial credit spread as recommended by the Basel Committee on Banking Supervision.

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

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

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13.7. For guidance on the tax treatment applicable to the issuance of IT1 capital instruments, please refer to the “Guidelines for Tax Treatment of Issuance of Innovative Tier 1 Capital Instruments by Banks/Financial Institutions (FI)” issued by the Technical Committee of Lembaga Hasil Dalam Negeri (Inland Revenue Board).

14. Hybrid Tier 2 Capital Instruments

14.1. For the purpose of inclusion as Tier 2 capital, hybrid (debt/ equity) 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 option of the holder or without the prior consent of the Bank;
- iii) Available to participate in losses without the banking institution being obliged to cease operations; and
- iv) Service obligations can be deferred by the banking institution where the profitability of the institution would not support payment.

14.2. Hybrid capital instruments which may be eligible for inclusion as Tier 2 capital are cumulative preference shares, perpetual loan stocks and mandatory convertible loan stocks (e.g. irredeemable convertible unsecured loan stocks or ICULs).

14.3. Hybrid capital instruments which do not fully meet the requirements in paragraph 14.1 above may be eligible for inclusion as Tier 2 capital under the category of subordinated term debt/ sukuk.

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15. Subordinated Debt Instruments / Sukuk

15.1. Unlike the hybrid capital instruments, sub-debt instruments/ sukuk are not normally available to participate in the losses of a banking institution on a going-concern basis and can only absorb losses in a liquidation. The items under this category would, subject to the approval of the Bank on a case-by-case basis, include term debt/ sukuk and limited life redeemable preference shares which do not fully meet the requirements enumerated in Section **Error! Reference source not found.** 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 instrument should be subject to a straight line amortisation over the last 5 years of its maturity; and
- v) There should be no restrictive covenants.

PART E CIRCULARS AND GUIDELINES SUPERSEDED

With the issuance of this guideline, the following circulars and guidelines shall be superseded:

Circulars/ Guidelines Number	Title	Date issued
2101/4/4/1	Capital Adequacy Requirement Risk-weighted Ratio.	4 August 1989.
2201/4/4/1	Daily Compliance with Capital Adequacy Ratio.	22 September 1990.
2201/201/1	Risk-weighted Capital Ratio – Submission by Computer Media.	22 September 1990.
2201/201/1	Return on Risk-weighted Capital Ratio (RWCR) – Submission by Computer Media.	12 November 1990.
2101/4/41	Risk-weighted Capital Adequacy Ratio:- (i) Inclusion of Half Year Profits as part of capital (ii) Treatment of Subordinated Loans Granted to Overseas Financial Institutions.	14 December 1990.
2201/010/1	Publication of Half-Yearly Accounts and Inclusion of Half-Year Profits in the Computation of Capital Funds.	16 September 1994.
2201/010/1/ MI/JM/OWK	Keuntungan Setengah Tahun Dalam Pengiraan Dana Modal.	22 August 1996.
2101/4/4/1/ MI/TKL	Pengiraan Nisbah Wajaran Risiko Modal (RWCR) Harian.	17 September 1996.
36/96/BI	Pelarasan Kepada Keperluan Modal Berwajaran Risiko: - Pinjaman Stok Tidak Bercagar Boleh Tukar dan Tidak Boleh Tebus. - Pinjaman Tempoh Subordinat.	20 December 1996.

BNM/RH/GL 007-15	Prudential Financial Policy Department and Islamic Banking and Takaful Department	Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks (General Requirements and Capital Components)	Page 24/27
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70/98/BI	Pelarasan Kepada Rangka Kerja Keperluan Nisbah Modal Berwajaran Risiko: - Pinjaman Tempoh Subordinat. - Peruntukan Am.	11 November 1998.
99/98/FC	Minimum Requirement on Risk-weighted Capital Ratio and Capital Funds.	31 December 1998.
56/2000/BI	Inclusion of Half Year Profit in the Capital Fund.	7 November 2000.
17/2004/CB/FC/MB/DH	Capital Treatment for Holdings of Other Financial Institutions Capital Instruments.	2 July 2004.
53/2004/CB/FC/MB/DH	Innovative Tier 1 Capital.	24 December 2004.
2201/000/4/4/1/MZ/NMK	Capital Treatment on Holdings of Non-Innovative Tier 1 Capital Instruments and Tax Treatment on Issuance of Innovative Tier 1 Capital Instruments.	6 March 2006.
BNM/RH/GL 001-20	Risk-weighted Capital Adequacy Framework (General Requirements and Capital Components).	20 September 2007.

PART F APPENDICES

16. Appendix I Illustration on the Calculation of the Non-Deduction Rule

Scenario 1: Subscription does not exceed 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 base is RM440m.

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%

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 Y subscribes RM200m of the capital instruments issued by Bank B. Bank B has a capital base of RM400m, while Bank Y's capital base is RM445m. In addition, Bank Y has an outstanding cumulative amount eligible for non-deduction from previous subscriptions totalling RM50m.

10% of issuer's capital base (a=10%RM400m)	15% of investor's capital base (b=15%RM445m)	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	67	40	40	65	25%

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 Y's current subscriptions of RM50m. The capital base has to be adjusted to reflect the future holdings of Bank B'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 Y's outstanding subscription and RM15m from Bank B's issuance). This represents 25% of Bank Y's capital base (RM260m, adjusted after deduction for holdings of Bank B's issuance).

17. Appendix II Illustration on the Limit of IT1 Capital Instruments

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

18. Appendix III Illustration for Determining the Swap Spread

1. Determining the swap spread:

INITIAL

Index basis (10-year MGS ⁱ)	5.0%
Credit spread	2.0%
Coupon rate	7.0%

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	7.0%

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%
	7.5%
Step-up (100 b.p)	1.0%
	8.5%
Less: Swap spread	(0.5%)
Stepped-up coupon rate	8.0%

ⁱ Index basis and figures used are for illustration purposes only.