

**IMPLEMENTATION GUIDANCE ON
CAPITAL ADEQUACY FRAMEWORK FOR ISLAMIC BANKS (CAPITAL
COMPONENTS)**

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This document *supplements* the *Capital Adequacy Framework for Islamic Banks (Capital Components)* by addressing interpretation queries likely to be faced by Islamic banking institutions in implementing the Framework. The questions are grouped according to the relevant paragraphs of the Framework.

Common Equity Tier 1 (CET1) Capital

1. When should the electable portion of a dividend under a dividend reinvestment programme be deducted in the calculation of CET1 Capital?
[Paragraph 11.1(c)]

In general, a dividend is required to be deducted in the calculation of CET1 Capital when declared in accordance with the *Malaysian Financial Reporting Standard*.

However, where a portion of the dividend declared may be reinvested under a dividend reinvestment plan (the electable portion), the amount of declared dividend to be deducted in the calculation of CET1 Capital may be reduced as follows:

- i. where an irrevocable written undertaking from the shareholder has been obtained to reinvest the electable portion of the dividend, the amount used to purchase new ordinary shares issued by the Islamic banking institution (i.e. new ordinary shares must be generated); or
- ii. where there is no irrevocable written undertaking provided, the average of the preceding 3-year¹ take-up rates subject to the amount being not more than 50% of the total electable portion of the dividend.

For the avoidance of doubt, the electable portion of the dividend used to fund the purchase of existing ordinary shares (e.g. treasury shares) is not allowed to be used to offset the amount of declared dividend.

2. Where associates and joint ventures are accounted for under the equity method, are earnings of such entities eligible for inclusion in the CET1 Capital of the group?
[Paragraph 11.1(c)]

Yes, to the extent that they are reflected in retained earnings and other disclosed reserves of the group and not excluded by any of the regulatory adjustments as set out in Part E of the Framework.

¹ If less than 3 preceding years, the available average historical take-up rates.

Additional Tier 1 and Tier 2 capital instruments

3. What will be considered to be an incentive to redeem? [Paragraphs 15.1(d) and 16.1(d)]

The following list provides some examples, which are not exhaustive, of what would be considered to be an incentive to redeem:

- i. a call option combined with an increase in the credit spread of the capital instrument if the call is not exercised;
- ii. a call option combined with a requirement or an investor option to convert the capital instrument into ordinary shares if the call is not exercised; and
- iii. a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (i.e. the fixed rate paid to the call date to receive the second reference rate). For example, if the initial reference rate is 0.9%, the credit spread over the initial reference rate is 2% (i.e. the initial payment rate is 2.9%), and the swap rate to the call date is 1.2%, a credit spread over the second reference rate greater than 1.7% (2.9-1.2%) would be considered an incentive to redeem.

Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem. However, the Islamic banking institution must not do anything that creates an expectation that the call will be exercised, nor can the Islamic banking institution assume that the Bank's approval will be granted for the purpose of satisfying investor expectations that a call will be exercised.

For the avoidance of doubt, the derecognition of a Tier 2 capital instrument in the final four years of its contractual maturity will not be viewed as an incentive to redeem.

4. **An instrument is structured with a first call date after 5 years but thereafter is callable quarterly at every interest payment due date (subject to the Bank's approval). The instrument does not have a step-up. Does the instrument meet the criteria in terms of being perpetual with no incentive to redeem?**

[Paragraph 15.1(d) and 15.1(e)]

Yes, provided that there is no maturity date, no expectation created that the call will be exercised and the exercise of the call option is at the discretion of the Islamic banking institution.

5. **One of the criteria for Additional Tier 1 capital instruments is for the distribution/payments to be at the full discretion of the Islamic banking institution, which means features such as dividend pushers are prohibited. But what about dividend stoppers?**

i. **Are dividend stopper arrangements acceptable if they stop dividend/coupon payments on ordinary shares if a dividend/coupon is not paid on its Additional Tier 1 capital instruments?**

ii. **Are dividend stopper arrangements acceptable if they stop dividend/coupon payments on other Additional Tier 1 capital instruments in addition to dividends on ordinary shares?**

[Paragraph 15.1(g)(i)]

Dividend stopper arrangements that stop dividend payments on ordinary shares or on other Additional Tier 1 capital instruments are not prohibited. However, stoppers must not impede the full discretion that Islamic banking institution must have at all times to cancel distributions/payments on the Additional Tier 1 capital instrument, nor must they act in a way that could hinder the recapitalisation of the Islamic banking institution [see paragraph 14.1(xi)]. For example, it would not be permitted for a stopper on an Additional Tier 1 capital instrument to:

- i. attempt to stop payment on another capital instrument where the payments on this other capital instrument were not also fully discretionary; and
- ii. otherwise impede the normal operation of the Islamic banking institution or any restructuring activity intended to facilitate the recovery/resolution of a Islamic banking institution.

A stopper may act to prohibit actions that are equivalent to the payment of a dividend, such as the Islamic banking institution undertaking discretionary share buybacks.

6. **“The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the Islamic banking institution or any of its affiliated entities”. Can the dividend/coupon rate be based on movements in a market index? Is resetting of the spread permitted at all? Does the criterion prevent the use of a reference rate for which the Islamic banking institution is a reference entity (e.g. KLIRR)?**
[Paragraph 15.1(h) and 16.1(h)]

The aim of the criterion is to prohibit the inclusion of capital instruments where the credit spread of the capital instrument will increase as the credit standing of the Islamic banking institution deteriorates. An Islamic banking institution may use a broad index as a reference rate in which the Islamic banking institution is one of the reference entities, although the reference rate should not exhibit significant correlation with the Islamic banking institution’s credit standing. If an Islamic banking institution plans to issue capital instruments where the spread is linked to a broad index in which the Islamic banking institution is one of the reference entities, the banking institution should ensure that the dividend/coupon is not credit sensitive.

Minority interest and capital instruments issued out of consolidated subsidiaries and held by third parties

7. **How should the surplus capital be calculated if the subsidiary is not regulated on a stand-alone basis but is still subject to consolidated supervision?**
[Paragraph 17]

The surplus capital is calculated based on the formulae as set out in paragraph 16 of the Framework.

In addition, all calculation must be undertaken in respect of the subsidiary on a sub-consolidated basis (i.e. the subsidiary must consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered operationally impractical, the Islamic banking institution may elect to give no recognition in consolidated capital of the group to the capital issued by the subsidiary to third parties.

Regulatory adjustments

- 8. Any goodwill included in the valuation of significant capital investments in unconsolidated entities must be deducted in the calculation of CET1 Capital. Does this apply to significant capital investments accounted for using the equity method?**
[Paragraph 18.1]

Yes. Under the equity method, the carrying amount of the investment includes goodwill. In line with paragraph 17.1, an Islamic banking institution should calculate a goodwill amount as at the acquisition date by separating any excess of the acquisition cost over the investor's share of the net fair value of the identifiable assets and liabilities of the unconsolidated entities. In accordance with applicable accounting standards, this goodwill amount may be adjusted for any subsequent impairment losses and reversal of impairment losses assigned to the initial goodwill amount.

- 9. Would equity investments in Cagamas Berhad and Credit Guarantee Corporation Malaysia Berhad be deemed as investments in capital instruments of financial institutions for the purpose of this Framework?**
[Paragraph 30.1, footnote 81]

No. For the purpose of this Framework, equity investments in Cagamas Berhad and Credit Guarantee Corporation will be risk-weighted at 100%, in accordance with paragraph 2.44, 3.4, and 3.195 of the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*.

- 10. Is provision of capital support by way of guarantee or other capital enhancements treated as capital invested in financial institutions?**
[Paragraph 30.1, footnote 81]

Yes. It is treated as capital in respect of the maximum amount that could be required to be paid out on any such guarantee.

- 11. Islamic banking institutions may have market risk hedging positions in place for investments that are held in their trading book. If the investments were excluded while leaving the hedges behind in the market risk calculation, RWAs could potentially increase. In such case, can an Islamic banking institution choose to include the trading book positions in their market risk calculations?**
[Paragraphs 30.1(b) and 30.4]

For positions that are hedged against market risk, but where the hedge does not qualify for offsetting the gross long position for the purpose of determining the amount to be deducted, an Islamic banking institution may choose to

continue to include the long exposure in their market risk calculations (in addition to deducting the exposure). Where the hedge does qualify for offsetting the gross long position, both the hedged long and short position can be, but does not have to be, excluded from the market risk calculations.

12. For purposes of the corresponding deduction approach, how will the instruments from other financial industries or jurisdictions be mapped to an Islamic banking institution's regulatory capital?

[Paragraph 30.3]

In determining which tier of capital an investment in a capital instrument of another financial institution shall be deducted, an Islamic banking institution should first consider the features of the instrument and determine which tier of capital the instrument would qualify if it was issued by the Islamic banking institution itself.

Where an instrument is counted as a regulatory capital instrument by the relevant supervisory authority over that financial institution, an Islamic banking institution investing in such an instrument should consider both how the instrument generally corresponds to the tiers of capital under Basel III, and how relevant supervisory authority tiers the instrument, and apply corresponding deductions to whichever is the higher tier of capital. If the treatment remains unclear, the investment in the capital instrument is to be considered as an ordinary share and thus deducted in the calculation of CET1 Capital.

Regulatory process and submission requirements

13. Will the external legal opinion and accounting confirmation be disclosed to any other party, other than the Bank?

[Paragraphs 35.1 (c) and (d)]

Yes, where relevant to the Malaysia Deposit Insurance Corporation (PIDM).

Transitional arrangements

14. What happens to share premium (stock surplus) associated with grandfathered instruments?

[Paragraph 37.7]

Share premium (stock surplus) only meets the criteria for inclusion in capital if it is related to a capital instrument that meets the criteria. The share premium of capital instruments that do not meet the criteria, but which are eligible for the transitional arrangements, should instead be included in the base for the transitional arrangements.

15. How do the transitional arrangements apply to capital instruments denominated in a foreign currency along with any potential hedges of the nominal amount of those capital instruments?

[Paragraph 37.7]

The total amount of such capital instruments that no longer meet the criteria for inclusion in the relevant tier of capital are included in the base and instrument eligible on the phase-out treatment should be limited by the cap from 1 January 2013 onwards. To calculate the base, capital instruments denominated in a foreign currency that no longer qualify for inclusion in the relevant tier of capital should be included using their value in the reporting currency of the Islamic banking institution as at 1 January 2013. The base will therefore be fixed in the reporting currency of the Islamic banking institution throughout the transitional period.

During the transitional period, capital instruments eligible for the phase-out treatment which are denominated in a foreign currency should be valued as they are reported on the balance sheet of the Islamic banking institution at the relevant reporting date (adjusting for any derecognition in the remaining four years of any Tier 2 capital instrument) and will be subject to the cap.

16. How would an investing Islamic banking institution apply the corresponding deduction approach during the transitional phase? For example, if a non-common equity instrument is being phased out from Tier 1 by the issuing Islamic banking institution, should the investing Islamic banking institution use the full value of the instrument or the amount recognised by the issuing Islamic banking institution (i.e. the phased-out value) to determine the size of the holding subject to the deduction treatment?

[Paragraphs 30.2 and 37.7]

During the period in which instruments that do not meet the criteria for inclusion are being phased out from regulatory capital (i.e. from 1 January 2013 to 1 January 2022) Islamic banking institutions must use the full value of the relevant capital instruments they hold in order to calculate the amount to be subject to the deduction treatment as set out in paragraph 30. For example, assume that an Islamic banking institution holds a capital instrument with a value of 100 on its balance sheet and the issuer of the capital instrument only recognises 50 in its Tier 1 capital (i.e. due to the application of the phasing-out requirements). In this case, the investing Islamic banking institution must apply the corresponding deduction approach set out in paragraphs 30 on the basis that it has an investment of 100 in Additional Tier 1 instruments.

