BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Transitional arrangements for regulatory capital treatment of accounting provisions

Exposure Draft

Applicable to:
Prescribed development financial institutions

Issued on: 30 September 2020

BNM/RH/ED 035-4

This Exposure Draft sets out the Bank's proposals on the transitional arrangements for regulatory capital treatment of accounting provisions. Prescribed development financial institutions (DFIs) which elect to apply the transitional arrangements are allowed to add back a portion of the Stage 1 and Stage 2 provisions for expected credit losses (ECL) to Common Equity Tier 1 Capital over a four-year period from financial year beginning 2020 or a three-year period from financial year beginning 2021. The proposals are consistent with the guidance issued by the Basel Committee on Banking Supervision on *"Regulatory treatment of accounting provisions – interim approach and transitional arrangement" (March 2017)* and *"Measures to reflect the impact of Covid-19" (April 2020).* This Exposure Draft is to be read together with the policy document on *Capital Framework for Development Financial Institutions*.

The Bank invites written feedback on the proposals in this Exposure Draft, including suggestions on areas to be clarified and alternative proposals that the Bank should consider. The written feedback should be supported with clear rationale, including accompanying evidence or illustration where appropriate, to facilitate an effective consultation process.

Responses must be submitted to the Bank by 30 October 2020 to−

Pengarah
Jabatan Kewangan Pembangunan dan Rangkuman Kewangan
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur
Email: dfia@bnm.gov.my

Electronic submission is encouraged. Submission received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

In the course of providing your feedback, you may direct queries to the following officers at 03-26988044:

(i) Azreena Abdul Wahab (azreena@bnm.gov.my ; ext. 8990)
(ii) Tengku Marzilawati (marzila@bnm.gov.my ; ext. 8484)
(iii) Tai Khai Ken (khaiken@bnm.gov.my ; ext. 8076)

Issued on: 30 September 2020

TABLE OF CONTENTS

PART A OVERVIEW

1 Introduction

1.1 This policy document sets out the transitional arrangements for regulatory capital treatment of accounting provisions.

1.2 Prescribed development financial institutions (DFIs) which elect to apply the transitional arrangements are allowed to add back a portion of the Stage 1 and Stage 2 provisions for expected credit losses (ECL) to Common Equity Tier 1 Capital over a four-year period from financial year beginning 2020 or a three-year period from financial year beginning 2021.

1.3 The transitional arrangements are consistent with the guidance issued by the Basel Committee on Banking Supervision on *"Regulatory treatment of accounting provisions – interim approach and transitional arrangement" (March 2017)* and *"Measures to reflect the impact of Covid-19" (April 2020)*.

2 Applicability

2.1 This policy document is applicable to a DFI under the Development Financial Institutions Act 2002 (DFIA) that provides a notification to the Bank in accordance with paragraphs 7.1 and 7.2.

3 Legal Provisions

3.1 The requirements in this policy document are specified pursuant to sections 41(1) and 116(1) of the DFIA.

3.2 The guidance in this policy document is issued pursuant to section 126 of the DFIA.

4 Effective date

4.1 This policy document comes into effect as follows:

(a) beginning on or after 1 January 2020 for a DFI which elects to apply the transitional arrangements for four financial years; or
(b) beginning on or after 1 January 2021 for a DFI which elects to apply the transitional arrangements for three financial years.

5 Interpretation

5.1 The terms and expression used in this policy document shall have the same meanings assigned to them in the DFIA and the policy document on *Capital Framework for Development Financial Institutions* issued on 22 February 2008 and as amended on 27 March 2018, unless otherwise defined in this policy document.

5.2 For the purpose of this policy document–

"S" denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretative, supplemental and transitional provisions that must be complied with. Non-compliance may result in enforcement actions;

"G" denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted.

6 Related legal instruments and policy documents

6.1 This policy document must be read together with other relevant legal instruments and policy documents that have been issued by the Bank, in particular the policy document on *Capital Framework for Development Financial Institutions* issued on 22 February 2008 and as amended on 27 March 2018.

PART B TRANSITIONAL ARRANGEMENTS

7 Transitional arrangements for DFIs

Provisions for expected credit losses (ECLs)

S 7.1 A DFI shall make a one-time election on whether or not to apply the transitional arrangements as specified in paragraphs 7.3 to 7.6 no later than 1 December 2021. Once an election is made−

(a) the requirements as set out in paragraphs 7.3 to 7.6 shall apply prospectively from the financial year beginning on the year of election; and
(b) the election is irrevocable throughout the transition period.

S 7.2 Where a DFI elects to apply the transitional arrangements, the DFI shall notify the Bank in writing at least one month before the transitional arrangements are applied. The notification shall be submitted to−

Pengarah
Jabatan Penyeliaan Perbankan
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur

S 7.3 A DFI is allowed to add back the amount of loss allowance measured at an amount equal to 12-month and lifetime expected credit losses to the extent they are ascribed to non-credit-impaired exposures (hereinafter referred to as Stage 1 and Stage 2 provisions) to Tier 1 Capital.

S 7.4 The amount of Stage 1 and Stage 2 provisions to be added back to Tier 1 Capital shall be calculated as follows:

$$\boxed{\text{Add-back} = \max \{0; (\text{Provisions}_{\text{Current}} - \text{Provisions}_{\text{Base}}) \times F\}}$$

where–

Add-back	Amount of Stage 1 and Stage 2 provisions eligible to be added back to Tier 1 Capital as at reporting financial year
$\text{Provision}_{\text{Current}}$	Total Stage 1 and Stage 2 provisions as at reporting date
$\text{Provision}_{\text{Base}}$	Total Stage 1 and Stage 2 provisions as at the financial year beginning on the year of election

F Add-back factor for reporting financial year, as follows:

Financial Year	Add-back factor (%)
2020	100
2021	100
2022	75
2023	50

S 7.5 A DFI shall include the amount of Stage 1 and Stage 2 provisions not eligible to be added back to Tier 1 Capital in the calculation of Tier 2 Capital in accordance with paragraph 8.7(v) of the policy document on *Capital Framework for Development Financial Institutions*.

S 7.6 A DFI applying the transitional arrangements shall disclose the following in its annual financial statement:

(a) a description of the transitional arrangements, including the financial year where the transitional arrangements is first applied and duration of the application; and

(b) the comparison of−
(i) the capital ratios computed in accordance with the transitional arrangements; and
(ii) the capital ratios had the transitional arrangements not been applied.

G 7.7 An illustration of the transitional arrangements specified in paragraphs 7.4 to 7.5 is provided in Appendix 1.

8 Reporting requirements

S 8.1 Where a DFI elects to apply the transitional arrangements as set out in paragraphs 7.3 to 7.6, the DFI shall−

(a) complete two reporting forms “Capital Framework for Development Financial Institutions” based on requirements−
(i) computed in accordance with the transitional arrangements; and
(ii) had the transitional arrangements not been applied; and

(b) in respect of paragraph 8.1(a)(i), report the add-back amount under Tier 1 Capital worksheet.

Questions

1. Would your institution consider electing to apply the transitional arrangements?

   If yes,

   a. would you elect to apply the transitional arrangement from financial year 2020 or 2021?
   b. please provide preliminary impact analysis on your capital ratios using the reporting template provided.

   If not,

   c. please provide your rationale.
   d. would a blanket implementation approach, with an option to 'opt-out' be preferred?

2. Please specify any implementation concerns and system challenges that your institution may face in implementing this transitional arrangement.

APPENDICES

Appendix 1 Illustration of transitional arrangements for provisions for expected credit losses (ECLs)

Scenario 1: Bank A has elected to apply the transitional arrangements for financial year beginning 1 January 2020.

- On 1 January 2020 (baseline), Bank A has RM100 million Stage 1 and Stage 2 provisions for its exposures.
- The amount of Stage 1 and Stage 2 provisions increased to RM150 million as at 31 March 2021.
- The amount of Stage 1 and Stage 2 provisions increased to RM200 million as at 31 May 2022.

For reporting period as at 31 March 2021, the add back amount is computed as follows:

$$\begin{aligned} \text{Add-back} &= \max\{0; (\text{Provisions}_{\text{Current}} - \text{Provisions}_{\text{Base}}) \times F\} \\ &= \max\{0; (\text{RM150 million} - \text{RM100 million}) \times 100\%\} \\ &= \max\{0; \text{RM50 million}\} \\ &= \text{RM50 million} \end{aligned}$$

Since 100% of the increase in the Stage 1 and Stage 2 provisions is added back to Tier 1 Capital, there is no remaining amount of Stage 1 and Stage 2 provisions to be added back to Tier 2 Capital.

For reporting period as at 31 May 2022, the add back amount is computed as follows:

$$\begin{aligned} \text{Add-back} &= \max\{0; (\text{Provisions}_{\text{Current}} - \text{Provisions}_{\text{Base}}) \times F\} \\ &= \max\{0; (\text{RM200 million} - \text{RM100 million}) \times 75\%\} \\ &= \max\{0; \text{RM75 million}\} \\ &= \text{RM75 million} \end{aligned}$$

The amount of Stage 1 and Stage 2 provisions not added back to Tier 1 Capital of RM25 million shall be added back to Tier 2 Capital[1].

[1] As specified in paragraph 7.5.

Appendix II

Implementation guidance on Capital Framework for Prescribed Development Financial Institutions

1. **What is the base year for DFIs with financial year end other than December e.g. March or June?**
[Paragraph 7.1(a)]

The base year is the financial year beginning on the year of election, as illustrated below:

Financial year beginning	Election (one-time)	Base year
1 January 2020	Anytime from now until Dec 2020	1 January 2020
	Anytime in 2021	1 January 2021
1 July 2020	Anytime from now until Dec 2020	1 July 2020
	Anytime in 2021	1 July 2021

2. **For DFIs which decide to apply the transitional arrangements in 2021, are they allowed to apply the requirements retrospectively for financial year 2020?**
[Paragraph 7.1(a)]

No. DFIs which elected to apply the transitional arrangements in 2021 may only apply these requirements for the remaining three-year financial period beginning 2021 with the add-back factors of 100%, 75% and 50% respectively.

3. **Once a DFI has decided to apply the transitional arrangements, can the DFI choose to opt-out before the financial year 2023?**
[Paragraph 7.1(b)]

No. Once a DFI has elected for the transitional arrangements, the DFI must apply the requirement over a four-year financial period (or a three-year financial period for those elected in 2021).

4. Where the provisions are eligible to be added back to Tier 1 Capital, are the associated deferred tax assets excluded from the amount to be deducted from Tier 1 Capital?
[Paragraph 7.4 of this policy document] and [paragraph 8.11 of the policy document on *Capital Framework for Development Financial Institutions*.]

No. A DFI shall continue to deduct the full amount of the deferred tax assets in the calculation of Tier 1 Capital.

5. A DFI decides to apply the transition arrangements in October 2020. Should the DFI recalculate its Tier 1 Capital Ratio for the previous reporting periods, including statistical resubmission?
[Paragraphs 7.1 and 8.1]

No. A DFI shall apply the transitional arrangements prospectively as illustrated below:

Financial year beginning	Election (one-time)	Reporting period
1 January 2020	October 2020	• For monthly reporting, from October 2020 position • For quarterly reporting, from 4Q 2020 position i.e. quarter ended 31 December 2020
1 July 2020	October 2020	• For monthly reporting, from October 2020 position • For quarterly reporting, from 4Q 2020 position i.e. quarter ended 31 December 2020
	April 2021	• For monthly reporting, from July 2021 position • For quarterly reporting, from 3Q 2021 position i.e. quarter ended 30 September 2021

6. Which capital ratios should be reported for the purpose of financial reporting?
[Paragraph 7.6]

For a DFI which elect to apply the transitional arrangements, the disclosure in the financial statement shall be the capital ratios computed in accordance with the transitional arrangements i.e. after adding back the Stage 1 and Stage 2 provisions allowed under the transitional arrangements.

7. How do the transitional arrangements apply to other regulatory requirements for example Single Counterparty Exposure Limit? [Paragraph 7.6]

A DFI shall apply the capital ratios computed in accordance with the transitional arrangements for the purpose of compliance with other regulatory requirements.