Transitional Arrangements for Regulatory Capital Treatment of Accounting Provisions

Exposure Draft

Applicable to:
1. Licensed banks
2. Licensed Islamic banks
3. Licensed investment banks

Issued on: 25 September 2020

BNM/RH/ED 029-18

This Exposure Draft sets out the Bank's proposals on the transitional arrangements for regulatory capital treatment of accounting provisions. Banking institutions[1] 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 of 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 documents on *Capital Adequacy Framework (Capital Components)* and *Capital Adequacy Framework for Islamic Banks (Capital Components)* dated 5 February 2020, with the new paragraphs to be added in the policy documents.

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 **23 October 2020** to−

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Jabatan Dasar Kewangan Pruden
Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur
Email: pfpconsult@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) Syazwani Hamsani (wani@bnm.gov.my ; ext. 8869)
(ii) Mohammad Aidil Mat Aris (aidilma@bnm.gov.my ; ext. 7687)
(iii) Liang Kai Wen (kaiwen@bnm.gov.my ; ext. 8076)

[1] Includes Islamic banking institutions.

The policy documents on Capital Adequacy Framework (Capital Components) and Capital Adequacy Framework for Islamic Banks (Capital Components) will be amended to include the following new paragraphs.

PART A OVERVIEW

2 Applicability

2.2 Paragraphs 37.14 to 37.19 are applicable to a banking institution[2] that provides a notification to the Bank in accordance with paragraphs 37.12 and 37.13.

4 Effective date

4.2 Paragraphs 37.14 to 37.19 come into effect as follows:

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

PART F OTHER REQUIREMENTS

36 Statistical reporting requirements

36.3 For a banking institution applying the transitional arrangements as set out in paragraphs 37.14 to 37.19, the banking institution shall−

(a) complete two reporting forms "Capital Adequacy Framework (Capital Components)" or "Capital Adequacy Framework for Islamic Banks (Capital Components)" 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 36.3(a)(i), report the add-back amount under "Other CET1 regulatory adjustments specified by the Bank" (Row 63) in the "C3.(RegAdj)" or "C3i.(RegAdj)" worksheet.

[2] Includes Islamic banking institutions.

PART G TRANSITIONAL ARRANGEMENTS

37 Transitional arrangements for banking institutions

Provisions for expected credit losses (ECLs)

S 37.12 A banking institution shall make a one-time election on whether or not to apply the transitional arrangements as specified in paragraphs 37.14 to 37.19 no later than 1 December 2021. Once an election is made−

(a) the requirements as set out in paragraphs 37.14 to 37.19 shall apply prospectively from the financial year beginning on the year of election; and

(b) the election is irrevocable throughout the transition period.

S 37.13 Where a banking institution elects to apply the transitional arrangements, the banking institution shall notify the Bank in writing at least one month before the transitional arrangements is applied. The notification shall be submitted to−

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S 37.14 A banking institution 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 CET1 Capital.

S 37.15 The amount of Stage 1 and Stage 2 provisions to be added back to CET1 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 CET1 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 37.16 A banking institution shall include the amount of Stage 1 and Stage 2 provisions not eligible to be added back to CET1 Capital in the calculation of Tier 2 Capital in accordance with paragraphs 13.1(d) and 37.17.

S 37.17 In respect of Stage 1 and Stage 2 provisions allocated to exposures under the Internal Ratings-Based approach for credit risk, the calculation of the amount to be added back to CET 1 Capital under paragraph 37.15 shall be subject to the following:

(a) a banking institution shall not add back any provisions to CET1 Capital where there is a shortfall of eligible provisions[3] to expected losses[4] as at a reporting date; and

(b) in the case of a surplus of eligible provisions over expected losses as at a reporting date–

(i) the amount to be added back to CET1 Capital shall be the lower of the amount calculated under paragraph 37.15 and the surplus of eligible provisions over expected losses; and

(ii) no add back to Tier 2 Capital is allowed where the amount of provisions added back to CET1 Capital is capped by the surplus of eligible provisions over expected losses.

S 37.18 A banking institution adopting the Internal Ratings-Based approach for credit risk shall segregate the Stage 1 and Stage 2 provisions allocated to exposures under the Internal Ratings-Based approach and Standardised Approach[5] in the calculation of the add back under paragraph 37.15.

S 37.19 A banking institution applying the transitional arrangements shall disclose the following in the Pillar 3 disclosures[6]:

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

[3] Refer to footnote 71.
[4] Refer to footnote 72.
[5] Applicable to asset classes exempted from the Internal Ratings-Based approach.
[6] Refer to the policy documents on *Risk Weighted Capital Adequacy Framework (Basel II) - Disclosure Requirements (Pillar 3)* and *Capital Adequacy Framework for Islamic Banks (CAFIB) – Disclosure Requirements (Pillar 3).*

(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 37.20 An illustration of the transitional arrangements specified in paragraphs 37.15 to 37.18 is provided in Appendix 6.

Questions

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

   If yes,

   a. would you elect to apply the transitional arrangements 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. Do you agree that the transitional arrangements should only be applied to banking institutions (at entity and consolidated level), excluding financial holding company? If no, please explain any specific concerns you may have on this proposal.

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

APPENDICES

APPENDIX 6 Illustration of transitional arrangements for provisions for expected credit losses (ECLs)

Scenario 1: Bank A has elected to apply the transitional arrangements from 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 under the Standardised Approach.
- 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 CET1 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 CET1 Capital of RM25 million shall be added back to Tier 2 Capital[7] in accordance with the loss provisions limit as specified in paragraph 13.1(d)(ii).

[7] As specified in paragraph 37.16.

Scenario 2: Bank B has elected to apply the transitional arrangements from financial year beginning 1 April 2021.

- On 1 April 2021 (baseline), Bank B has RM RM50 million of Stage 1 and Stage 2 provisions for its exposures under the Standardised Approach and RM100 million of Stage 1 and Stage 2 provisions for its exposures under the Internal Ratings-Based approach.
- The amount of Stage 1 and Stage 2 provisions increased to RM75 million for exposures under the Standardised Approach and RM150 million for exposures under the Internal Ratings-Based approach as at 30 June 2021.
- Bank B has a surplus of eligible provisions over expected losses of RM45 million.
- No add back to CET1 Capital is allowed for financial year 2020 since Bank B has elected to apply the transitional arrangements from financial year beginning 2021.

For reporting period as at 30 June 2021, the add back amount is computed as follows:

(i) Exposures under the Standardised Approach

Add-back	=	max {0; ($Provisions_{Current}$ – $Provisions_{Base}$) x F}
	=	max {0; (RM75 million – RM50 million) x 100%}
	=	max {0; RM25 million}
	=	RM25 million

Since 100% of the increase in the Stage 1 and Stage 2 provisions for exposures under Standardised Approach is added back to CET1 Capital, there is no remaining amount of Stage 1 and Stage 2 provisions to be added back to Tier 2 Capital.

(ii) Exposures under the Internal Ratings-Based approach

Add-back	=	max {0; ($Provisions_{Current}$ – $Provisions_{Base}$) x F}
	=	max {0; (RM150 million – RM100 million) x 100%}
	=	max {0; RM50 million}
	=	RM50 million

Since the amount of add back for exposures under Internal Ratings-Based approach is higher than the surplus of eligible provisions over expected losses of RM45 million, Bank B is only allowed to add back RM45 million[8] to CET1 Capital. In addition, the provisions not eligible to be added back to CET1 Capital (i.e. RM 5 million) shall not be added to Tier 2 Capital[9].

Therefore, the total amount of Stage 1 and Stage 2 provisions added back to CET1 Capital for Bank B is RM70 million (i.e. RM25 million for exposures under the Standardised Approach and RM45 million for exposures under the Internal Ratings-Based approach). No amount of Stage 1 and Stage 2 provisions is added back to Tier 2 Capital.

[8] As specified in paragraph 37.17(b)(i).
[9] As specified in paragraph 37.17(b)(ii).

Scenario 3: Bank C has elected to apply the transitional arrangements from financial year beginning 1 January 2021.

- On 1 January 2021 (baseline), Bank C has RM100 million of Stage 1 and Stage 2 provisions for its exposures under the Internal Ratings-Based approach.
- The amount of Stage 1 and Stage 2 provisions increased to RM150 million as at 31 March 2022.
- Bank C has a surplus of eligible provisions over expected losses of RM45 million.
- No add back to CET1 Capital is allowed for financial year 2020 since Bank C has elected to apply the transitional arrangements from financial year beginning 2021.

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

$$\begin{aligned} \text{Add-back} &= \max\{0; (\text{Provisions}_{\text{Current}} - \text{Provisions}_{\text{Base}}) \times F\} \\ &= \max\{0; (\text{RM150 million} - \text{RM100 million}) \times 75\%\} \\ &= \max\{0; \text{RM37.5 million}\} \\ &= \text{RM37.5 million} \end{aligned}$$

Since the amount of add back is lower than the surplus of eligible provisions over expected losses of RM45 million, Bank C is allowed to add back RM37.5 million[10] to CET1 Capital. The remaining amount of RM7.5 million (RM45 million less RM37.5 million) shall be included in Tier 2 Capital[11] in accordance with the loss provisions limit as specified in paragraph 13.1(d)(i).

Scenario 4: Bank D has elected to apply the transitional arrangements from financial year beginning 1 July 2020.

- On 1 July 2020 (baseline), Bank D has RM100 million of Stage 1 and Stage 2 provisions for its exposures under the Internal Ratings-Based approach.
- The amount of Stage 1 and Stage 2 provisions increased to RM150 million as at 31 December 2020. However, Bank D also reported a shortfall of eligible provisions to expected losses of RM5 million.

For reporting period as at 31 December 2020, Bank D is not allowed to add back any provisions to CET1 Capital due to the shortfall of eligible provisions to expected losses in the current reporting period[12].

[10] As specified in paragraph 37.17(b)(i).
[11] As specified in paragraph 37.16.
[12] As specified in paragraph 37.17(a).

The implementation guidance on Capital Adequacy Framework (Capital Components) and Capital Adequacy Framework for Islamic Banks (Capital Components) will be amended to include the following new paragraphs.

17. What is the base year for banking institutions with financial year end other than December e.g. March or June?
[Paragraph 37.12(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 December 2020	1 January 2020
	Anytime in 2021	1 January 2021
1 July 2020	Anytime from now until December 2020	1 July 2020
	Anytime in 2021	1 July 2021

18. For banking institutions which decide to apply the transitional arrangements in 2021, are they allowed to apply the requirements retrospectively for financial year 2020?
[Paragraph 37.12(a)]

No. Banking institutions 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.

19. Once a banking institution has decided to apply the transitional arrangements, can the banking institution choose to opt-out before the financial year 2023?
[Paragraph 37.12(b)]

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

20. Where the provisions are eligible to be added back to CET1 Capital, are the associated deferred tax assets excluded from the amount to be deducted from CET1 Capital?
[Paragraphs 19.1 and 37.15]

No. A banking institution shall continue to deduct the full amount of the deferred tax assets in the calculation of CET1 Capital.

21. A banking institution decides to apply the transition arrangements in October 2020. Should the banking institution recalculate its CET1 Capital Ratio for the previous reporting periods, including statistical resubmission?
[Paragraphs 36.3 and 37.12]

No. A banking institution 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

22. Which capital ratios should be reported for the purpose of financial reporting?
[Paragraph 37.19]

For a banking institution which elects 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.

23. How do the transitional arrangements apply to other regulatory requirements for example Single Counterparty Exposure Limit?
[Paragraph 37.19]

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