

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Capital Adequacy Framework for Financial Holding Companies
(Banking Groups)

Discussion Paper

Issued on: 23 October 2014

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This discussion paper sets out the Bank's proposals on the capital adequacy requirements for financial groups headed by a financial holding company, pursuant to the exercise of the Bank's oversight power over financial groups as provided under Part VII of the Financial Services Act 2013 and Part VIII of the Islamic Financial Services Act 2013.

The Bank invites feedback on the proposals in this discussion paper, including any additional proposals that the Bank should consider. To facilitate the Bank's assessment, please support each feedback with a clear rationale, accompanying evidence or illustration, as appropriate.

Financial holding companies approved by the Bank are also requested to complete a one-off exercise to compute their consolidated capital ratios for 30 June 2014 financial position using the reporting template provided.

Feedback shall be submitted by 23 December 2014 to:

Pengarah
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 preparing your feedback, kindly direct any queries to Toh Ying Ying at yying@bnm.gov.my or 03-26988044 (ext. 8345) or Mohammad Aidil Mat Aris at aidilma@bnm.gov.my or 03-26988044 (ext. 7687).

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PART A OVERVIEW

1 Introduction

1.1 Capital adequacy is an integral component of the implementation of prudential standards for financial groups. It ensures that a financial group is adequately capitalised against any risks or difficulties in any entity in the group that could pose a threat to the viability of licensed institutions within the group.

1.2 This discussion paper therefore outlines the proposals to extend the capital adequacy requirements currently applicable to a licensed banking institution, to a financial group headed by a financial holding company which is engaged predominantly in banking activities[1].

1.3 The proposed framework aims to:

i. ensure that the group as a whole is adequately capitalised to support its group-wide risks;

ii. address the multiple gearing of capital and excessive leverage within the financial group which may undermine the financial strength of licensed institutions within the group; and

iii. achieve greater consistency in disclosed capital ratios between financial groups headed by a bank and by a financial holding company.

1.4 The group capital adequacy framework will supplement the existing capital requirements imposed on a licensed institution. Consequently, a licensed institution[2] within a financial group headed by a financial holding company shall continue to apply the relevant capital adequacy framework at the individual licensed institution and consolidated levels.

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[1] Paragraph 5.4 of the paper on *Approach to Regulating and Supervising Financial Groups*, 21 May 2014.

[2] Refers to a licensed person under the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA).

1.5 The longer transition arrangements proposed in this paper are expected to ensure that the financial holding company has sufficient time to address operational challenges and to manage the potential impact of compliance with the proposals.

PART B GROUP CAPITAL ADEQUACY

2 Approach to capital adequacy for financial groups which are engaged predominantly in banking activities

2.1 Where a financial group is headed by a licensed banking institution, the group is presently subject to group-wide capital requirements under the *Capital Adequacy Framework* which requires the application of the capital rules on both the entity and consolidated basis.

2.2 The Bank proposes to extend the capital adequacy requirements currently applicable to a licensed banking institution to a financial group headed by a financial holding company which is engaged predominantly in banking activities[3].

2.3 As a baseline proposal, all requirements as set out in the following policy documents shall apply to a financial holding company:

i. For a financial holding company approved under section 112 of the Financial Services Act 2013 (FSA)[4]:
   a. *Capital Adequacy Framework (Capital Components)*; and
   b. *Capital Adequacy Framework (Basel II – Risk-Weighted Assets).*

ii. For a financial holding company approved under section 124 of the Islamic Financial Services Act 2013 (IFSA):
   a. *Capital Adequacy Framework for Islamic Banks (Capital Components)*; and

[3] The predominant sector represents the primary financial business of the group. In cases where it may not be possible to clearly identify a predominant sector, the financial holding company is advised to engage with the Bank on the relevant sectoral rules to be applied.

[4] For clarity purposes, requirements on Islamic contracts in *Capital Adequacy Framework* shall also apply to any Islamic activities (which includes the offering of products or services based on Shariah contracts and investment in instruments structured using Shariah contracts) conducted by non-Islamic entities within the group.

b. *Capital Adequacy Framework for Islamic Banks (Basel II – Risk-Weighted Assets)*

(all four policy documents are hereafter referred to as "*Capital Adequacy Framework"*).

2.4 Exceptions to the requirements in the *Capital Adequacy Framework* are detailed out in Part C of this discussion paper.

3 Minimum capital adequacy and capital buffer requirements

3.1 A financial holding company will be required to comply with the following level of minimum capital adequacy ratios at the consolidated level:

Common Equity Tier 1 (CET1) Capital Ratio	Tier 1 Capital Ratio	Total Capital Ratio
4.5%	6.0%	8.0%

3.2 A financial holding company will be required to hold additional capital buffers above the minimum capital adequacy levels set forth under paragraph 3.1. These buffers comprise:

i. a Capital Conservation Buffer of 2.5% of total risk-weighted assets; and

ii. a Countercyclical Capital Buffer ranging between 0% and 2.5% of total risk-weighted assets, determined as the weighted-average of the prevailing countercyclical capital buffer requirements applied in the jurisdictions in which the group has credit exposures.

PART C COMPUTATION OF GROUP CAPITAL ADEQUACY

4 Level of application

4.1 A financial holding company will be required to calculate the capital adequacy ratios on a consolidated basis, based on the consolidated financial statements of the group[5]. The use of the consolidated financial statement will ensure that exposures from all entities within the group, including those entities that are not subject to regulatory capital requirements on an entity basis, are included in the computation of the group's capital ratio.

4.2 One of the key objectives of this framework is to ensure that the financial group is adequately capitalised to support its group-wide risks. This is adequately achieved by applying the proposed capital requirements to a financial holding company on a consolidated basis. Therefore, a financial holding company will not be required to apply this framework at the entity level.

4.3 For clarity purposes, the capital requirements will not be applied to the subsidiaries of a financial holding company, which are not regulated by the Bank.

[5] Consolidation of all subsidiaries, with the exception of insurance/takaful subsidiaries which shall be deducted in the calculation of Common Equity Tier 1 Capital.

5 Criteria for inclusion as regulatory capital

5.1 A financial holding company will be required to obtain the Bank's written approval prior to issuance of any capital instrument by:

i. the financial holding company, or

ii. an SPV to third parties,

and before recognising the instrument as regulatory capital at the consolidated level of the financial holding company.

5.2 In principle, the capital instrument issued by a financial holding company shall comply with all the criteria for inclusion in CET1 Capital, Additional Tier 1 Capital or Tier 2 Capital as set out in the *Capital Adequacy Framework*, including the requirement that the provisions governing the issuance of the capital instruments contain clauses which ensures the loss absorbent quality[6] of the capital instruments.

5.3 This framework requires that for the Additional Tier 1 or Tier 2 capital instrument issued by a fully consolidated subsidiary[7] and held by third party investors to be recognised in the consolidated capital of the financial holding company, the capital instrument shall contain an additional loss absorbency clause referenced to the financial group. For example, the provisions governing the Additional Tier 1 capital instrument issued by a banking subsidiary will contain an additional clause that require the Additional Tier 1 capital instrument to be written-off or be converted into ordinary shares if the consolidated level CET1 Capital Ratio of the financial group falls below 5.125%.

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6 Write-off or conversion mechanisms to achieve principal loss absorption and loss absorbency at the point of non-viability.

7 Includes both banking and non-banking subsidiaries but excludes insurance/takaful subsidiaries and other subsidiaries which are not consolidated for regulatory purposes.

Question 1

Please identify any potential operational and legal impediments that may hinder the write-off or conversion of Additional Tier 1 or Tier 2 capital instruments issued by subsidiaries of a financial holding company in the event the loss absorbency is triggered at the group level.

Question 2

Please provide details of preference shares and subordinated debt securities issued by the financial holding company that are outstanding as at 30 June 2014 in the reporting template (under the tab "FHC CapInst" tab).

6 Limited recognition of minority interest and capital instruments issued out of fully consolidated subsidiaries and held by third parties

6.1 Capital instruments issued by a fully consolidated subsidiary[7] of a financial holding company and held by third parties will only be recognised in the consolidated CET1 Capital, Tier 1 Capital and Total Capital of the financial holding company if these instruments meet the criteria for inclusion in CET1 Capital, Additional Tier 1 Capital or Tier 2 Capital, including the additional requirement on loss absorbency as proposed in paragraph 5.3. The amount to be recognised will be subject to the limit as set out in the *Capital Adequacy Framework.*

Question 3

Please provide details of Additional Tier 1 and Tier 2 capital instruments (including non-Basel III compliant instruments that are subject to the phase-out treatment) issued by consolidated subsidiaries of a financial holding company that are outstanding as at 30 June 2014 in the reporting template (under the tab "CapInst" tab).

7 Requirements for risk-weighted assets

7.1 In calculating the consolidated capital ratios, a financial holding company will apply the Bank's rules for computing the risk-weighted assets of the group. The requirements will also be applied to overseas banking subsidiaries which are subject to capital requirements of host jurisdictions at the entity level.

Question 4

For Islamic products, the capital requirements will be based on the underlying Shariah contracts as specified under the *Capital Adequacy Framework*. This requirement is intended to reflect the different risk profile of Islamic products. For application to the Islamic assets of non-banking entities or overseas banking institutions, different capital measurement system and processes may need to be in place.

i. Please identify any potential operational impediments or cost implications in applying the requirements of Islamic contracts to calculate the capital requirement of the Islamic assets in non-banking entities.

ii. Please provide details of product and services structured using Shariah contracts offered by non-banking entities within the group (e.g. Ijarah conducted by a leasing company, or asset management based on Islamic contracts).

iii. What is the ratio of Islamic assets in non-banking entities to total group assets?

7.2 In cases where a Malaysian licensed bank[8] within a financial group adopts an advanced approach for the computation of risk-weighted assets of a risk type[9], the Bank expects the financial holding company to apply a similar approach for the computation of the group risk-weighted assets of that risk type[10,11]. This will ensure a consistent measurement approach being applied for similar exposures across the group.

Question 5

What are the operational challenges that may arise in adopting an advanced approach for a risk type at the group level?

Question 6

The Bank is also considering that once a significant commercial bank, regardless of its domicile, within a financial group adopts an advanced approach for the computation of risk-weighted assets of a risk type, the entire financial group should also adopt a similar approach in computing the risk-weighted assets of that risk type. The Bank wishes to obtain the industry's views on this alternative proposal.

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8 Refers to a licensed person carrying on banking business under the FSA and the IFSA.

9 An advanced approach for a risk type refers to Internal Ratings Based Approach for credit risk, Internal Models Approach for market risk, and Standardised Approach or Alternative Standardised Approach for operational risk.

10 For credit risk, the adoption of the advanced approach can be done based on an asset class or a sub-class, and for market risk, the adoption of the advanced approach can be done based on a broad risk category.

11 For clarity purposes, the other banking subsidiaries do not necessarily have to adopt the similar approach for their entity level reporting.

7.3 The Bank acknowledges the additional demands placed on the operational capacity required to compute and aggregate risk exposures across the groups particularly under an advanced approach. In this respect, the financial holding company is expected to take early steps to develop and implement regulatory capital reporting systems across the group, including the overseas subsidiaries.

PART D PILLAR 2 AND PILLAR 3 REQUIREMENTS

8 Internal capital adequacy assessment process (ICAAP)

8.1 Pillar 2 of the *Capital Adequacy Framework* aims to ensure that a banking institution has adequate capital to support its operations at all times. It also promotes the adoption of a more forward-looking approach to capital management and encourages a banking institution to develop and employ more rigorous risk management techniques.

8.2 The Bank will extend the requirements under Pillar 2 to a financial group headed by a financial holding company on a consolidated basis.

8.3 As part of the requirements, the financial holding company will also be required to conduct periodic assessments on the appropriateness of capital distribution across the group, taking into consideration the potential impediments to the transferability of capital due to legal, regulatory or other constraints[12].

Question 7

The Bank is concerned that capital surpluses from subsidiaries within the group may not be freely transferable especially in times of stress.

i. Please list the impediments and challenges on capital mobility of each subsidiary, including whether the regulatory approval is required before capital surpluses (including dividend) can be transferred or repatriated.

ii. What are the safeguards and processes in place for the financial holding company to readily access the capital surpluses of the subsidiaries?

[12] For example, restrictions imposed by a foreign regulator to transfer surplus capital across borders, or approval required from the foreign regulator before dividend distribution.

9 Disclosure requirements

9.1 Improved transparency in the financial markets, underpinned by high quality and timely market disclosures, will enhance market discipline, market efficiency and confidence. The Pillar 3 disclosure requirements therefore aim to enhance transparency by setting the minimum requirements for disclosure of information on the risk management practices and capital adequacy of a banking institution. This will enable market participants to obtain greater insights on the risk exposures, risk assessment processes, capital structure and capital adequacy of the banking institution.

9.2 The Bank proposes to extend the Pillar 3 disclosure requirements to a financial group headed by a financial holding company on a consolidated basis.

PART E IMPLEMENTATION TIMELINE AND REGULATORY SUBMISSION

10 Implementation timeline

Minimum capital adequacy and capital buffer requirements

10.1 A financial holding company which is engaged predominantly in banking activities will be required to comply with the minimum capital adequacy requirements and capital buffer requirements, as set out in paragraphs 3.1 and 3.2 on a consolidated basis, beginning 1 January 2019.

10.2 A financial holding company will also be required to publicly disclose the capital adequacy positions on a consolidated basis in the financial statements beginning 1 January 2019.

10.3 To prepare for a smooth implementation of the group capital adequacy requirements in 2019, the Bank expects a financial holding company to put in place clear action plans and timeline for all significant work, which should also cover foreign subsidiaries, to be completed well in advance of the 1 January 2019 deadline. The board will be responsible for the oversight of the implementation of these plans.

Recognition of capital instruments as regulatory capital

10.4 Capital instruments issued by a financial holding company prior to 1 January 2019 will not be recognised as regulatory capital unless the following conditions are met:

i. the capital instruments meet all criteria for inclusion in Additional Tier 1 Capital or Tier 2 Capital; and
ii. the Bank's written approval has been obtained prior to issuance of the capital instruments.

For clarity purposes, any outstanding capital instruments issued by a financial holding company as at 31 December 2018 which do not meet all criteria for

inclusion in Additional Tier 1 Capital and Tier 2 Capital will be fully derecognised effective 1 January 2019.

Internal capital adequacy assessment process (ICAAP)

10.5 A financial holding company will be required to submit to the Bank a board-approved ICAAP document by 31 March 2020 based on the 31 December 2019 financial and capital positions. The document shall be comprehensive and reflective of the financial group's size, nature of business and complexity of business activities.

Disclosure requirements

10.6 A financial holding company will be required to apply the full Pillar 3 disclosure requirements which shall be published together with the financial statements for the financial reporting period beginning on and after 1 January 2019.

10.7 A financial holding company will also be required to make available on its website the full terms and conditions of all Additional Tier 1 and Tier 2 capital instruments not later than 2 weeks after the issuance of these capital instruments.

11 Regulatory approval process for the adoption of an advanced approach for the computation of risk-weighted assets of a risk type

11.1 A financial holding company will be required to obtain the Bank's written approval prior to adopting any of the following advanced approaches:

i. Internal Ratings-Based Approach for credit risk;
ii. Internal Model Approach for market risk; and
iii. The Standardised Approach or Alternative Standardised Approach for operational risk.

11.2 For the purpose of submitting an application to adopt the Internal Ratings-Based Approach for credit risk under paragraph 11.1(i):

i. for a financial group where the Malaysian licensed bank within the group has adopted the Internal Ratings-Based Approach prior to the date of issuance of this discussion paper:

a. the group must fully comply with all minimum requirements of the approach on a consolidated basis by 1 January 2019;

b. the group must submit the application, accompanied by all required information, to the Bank by 1 January 2017[13];

c. the Bank will inform its decision on the application and the commencement of parallel run by 31 December 2017; and

d. the Bank will inform its final decision on the migration to the approach by 1 January 2019.

ii. for a financial group where the Malaysian licensed bank within the group is planning to migrate to the Internal Rating-Based Approach for credit risk after the date of issuance of this discussion paper:

a. the group shall formally notify the Bank of its intention to migrate at least 3 years before the intended implementation date;

b. the group must submit the application, accompanied by all required information, to the Bank at least 2 years before the intended implementation date;

c. the group shall comply with all minimum requirements of the approach except in relation to the use of internal ratings, at the time of submission to the Bank under (b) above. In the case of the requirements on the use of internal ratings, the group shall demonstrate a credible track record showing that the rating systems which comply with the minimum requirements have been used for at least 1 year prior to the submission. The group may

[13] For clarity purposes, compliance with the minimum requirements of the approach is not required at the time of submission of the required information to the Bank. The group may utilise the time allocated for the review period by the Bank and the parallel run period to fully meet the minimum requirements by 1 January 2019.

utilise the time allocated for the review period by the Bank and the parallel run period to fully meet the use of internal ratings requirements;

d. the Bank will inform its decision on the application and whether the group can commence parallel run within 1 year from the receipt of the submission of the required information under (b) above; and

e. in the case where the Bank has agreed for the group to commence parallel run, the Bank will inform its final decision on the migration to the approach by the end of the parallel run period.

12 Regulatory submission of group capital positions

12.1 As part of the implementation of this framework, the Bank proposes to initiate a 3-year regulatory submission (i.e. 2016 to 2018) of the capital position of the financial holding companies on a consolidated basis prior to the formal implementation in 2019. This will allow the Bank sufficient time to assess the level of readiness of the financial groups as well as identify any potential transitioning issues.

12.2 A financial holding company will report the group capital position based on the frequency and the reporting templates which will be provided in the final policy document. However, compliance with the minimum levels and requirements is not expected before the framework is formally implemented in 2019.