PRUDENTIAL CONSOLIDATION AND DEDUCTION REQUIREMENTS

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PCD-A.1 Purpose

PCD-A.1.1 This Module sets out the regulatory rules for prudential consolidation and pro-rata consolidation for banks where they own controlling or significant minority stakes in regulated financial entities. It also sets out the framework for the prudential deductions from capital for (a) investments in regulated financial entities (below the significance threshold determined for consolidation and pro-rata consolidation), (b) significant investments in insurance entities (c) significant investments in commercial entities and (d) exposures to counterparties exceeding the large exposure limits as set out by CBB.

PCD-A.1.2 Consolidation and pro-rata consolidation, wherever referred to in this Module, denotes consolidation and pro-rata consolidation rules only for the purposes of computing regulatory minimum capital requirements and as such these do not impact on accounting consolidations and pro-rata consolidation of banks and banking groups, for which there are separate applicable standards and best practices.

PCD-A.1.3 For prudential purposes, CBB will supervise banks and banking groups on a consolidated basis, in accordance with consolidation and deduction rules outlined in this Module.

PCD-A.1.4 The rules for prudential consolidation and pro-rata consolidation are set out in PCD-1.

PCD-A.1.5 The rules for prudential deductions from capital are set out in PCD-2. The prudential framework is also applicable to banks on a standalone basis.

PCD-A.1.6 This Module complements the Module CA, which sets minimum capital requirements for licensed Islamic banks in Bahrain.

PCD-A.2 Definitions

PCD-A.2.1 **A banking group is a parent bank and all its subsidiaries.**

PCD-A.2.2 **A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another bank (known as the parent bank).**

PCD-A.2.3 **A parent bank is a bank which has one or more subsidiaries.**

PCD-A.2.4 **Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.**

PCD-A.2.5 Control is presumed to exist when the parent bank owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, the bank can clearly demonstrate that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

(a) power over more than half of the voting rights by virtue of an agreement (whether revocable or not) with other investors;
(b) power to govern the financial and operating policies of the entity under a statute or an agreement;
(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

PCD-A.2.6 A bank may own share warrants, share call options, equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the bank voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether the bank has the power to govern the financial and operating policies of another entity. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

PCD-A.2.7 In assessing whether potential voting rights contribute to control, the bank examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert.

PCD-A.2 Definitions (continued)

PCD-A.2.8 A parent bank loses control when it loses the power to govern the financial and operating policies of an investee so as to obtain benefit from its activities. The loss of control can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when a subsidiary becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

PCD-A.2.9 **Significant investments include:**

(a) investments in licensed banking, securities[1] or other financial entities from 20% to 50% of the investee's capital;

(b) investments in insurance entities of 20% or more of the investee's capital; and

(c) investments in commercial entities of 15% or more of the bank's capital.

PCD-A.2.10 **For the sake of clarity, investment management entities must be treated as financial entities (for further information, see paragraph PCD-1.1.2).**

PCD-A.2.11 **Minority interest is that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent bank.**

PCD-A.2.12 **Although consolidation and pro-rata consolidation rules outlined in this module are prescribed only for computing regulatory minimum capital, the procedures applied for such consolidation and pro-rata consolidation are performed in accordance with applicable accounting standards and best practices which may be subject to change from time to time.**

[1] Securities entities include category one and category two investment firms incorporated in Bahrain and equivalent entities incorporated outside Bahrain.

PCD-A.3 Module History

PCD-A.3.1 This Module was first issued in January 2008. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made: Chapter UG-3 provides further details on Rulebook maintenance and version control. The most recent changes made to this module are detailed in the table below:

Summary of changes

Module Ref.	Change Date	Description of Changes
PCD 1.1.1, 1.2.1 2.1, 2.3.3 & 2.4	Apr 2008	Minor guidance changes
PCD-2.1	Jan 2009	Clarification on risk weighting of listed and unlisted instruments

PCD-1.1 Banking, securities and other financial subsidiaries

PCD-1.1.1 **To the greatest extent possible, all banking and other relevant financial entities which are subsidiaries of a licensee bank will be captured through consolidation (or aggregation) for regulatory capital purposes (or deducted in line with chapter PCD-2). Thus, majority-owned or –controlled banking entities, securities entities (where such activities are subject to broadly the similar set of regulations or where securities activities are deemed banking activities) and other financial entities should generally be fully consolidated or aggregated for regulatory capital purposes. (See PCD-2.1.3 for possible exceptions to this treatment). Banks must notify the CBB of their proposed regulatory aggregation or consolidation approaches and agree them with the CBB and their external auditors.**

PCD-1.1.2 For the purpose of this module, a financial entity is an entity which conducts banking activities or other financial activities such as finance leasing, issuing credit cards, portfolio management, investment advisory, money changers, factoring, forfaiting, custodial and safekeeping services and other similar activities that are ancillary to the business of banking, whether or not the entity is regulated. For the sake of further clarity, financial entities do not include insurance entities (for further guidance on banking activities and regulated banking services, please see "Licensing and Authorisation Requirements Module").

PCD-1.1.3 **When recognising consolidated capital for regulatory capital purposes, the CBB will assess the appropriateness of including minority interest(s) arising from the consolidation of less than wholly owned banking, securities and other financial entities.**

PCD-1.1.4 Such minority interests will be included subject to their ability to absorb losses. However, if the transfer of minority interest capital is legally restricted or if minority interest capital is not readily available then such capital will not be eligible for inclusion in the group's capital. In cases where minority interest capital exceeds 5% of a bank's consolidated capital for regulatory capital purposes, the bank is required to demonstrate to CBB that minority interests recognised as capital are readily available to other group companies e.g. by producing legal proof from the concerned supervisor of subsidiary that there is no restriction on transfer of funds to other group companies.

PCD-1.1.5 For instances where it is not feasible or desirable to consolidate certain securities and other financial entities for regulatory capital purposes, banks are required to provide the CBB with sufficient evidence that such holdings are acquired through underwriting of the share issue and are held on a temporary basis in the ordinary course of business; or are subject to materially different regulation; or non-consolidation for regulatory capital purposes is otherwise required by law.

PCD-1.1 Banking, securities and other financial subsidiaries (continued)

PCD-1.1.6 With the exception of activities carried out in the ordinary course of business (like share underwriting), in cases where consolidation for regulatory capital purposes does not occur, the parent bank is required to report capital adequacy measures for the parent and subsidiary separately (see also chapter PCD-2).

PCD-1.2 Significant investments in banking, securities and other financial entities

PCD-1.2.1 **Significant investments (20% - 50%) in banking, securities and other financial entities, will be consolidated or aggregated on a pro-rata basis for regulatory capital purposes unless deducted in accordance with chapter PCD-2.**

PCD-1.2.2 However, the CBB must be satisfied that the parent bank with significant minority ownership is expected to support the entity to the extent of its proportionate ownership only. The parent bank will be required to demonstrate that other significant shareholders have the means and the willingness to proportionately support the financial entity. The bank should have joint control in the investee entity along with other parties. If there is no joint control and a single party can exercise control, prorata-consolidation for regulatory capital purposes can not applied.

PCD-1.2.3 For instances where it is not feasible or desirable to prorata-consolidate/aggregate certain securities and other financial entities for regulatory capital purposes, banks are required to provide the CBB with sufficient evidence that such holdings are acquired through underwriting of the share issue and are held on a temporary basis in the ordinary course of business; or are subject to materially different regulation; or non-prorata-consolidation for regulatory capital purposes is otherwise required by law.

PCD-1.2.4 With the exception of activities carried out in ordinary course of business (like share underwriting), in cases where prorata-consolidation for regulatory capital purposes does not occur, the bank is required to report capital adequacy measures for itself and the investee entity separately.

PCD-2.1 Investments in banking, securities and other financial entities

PCD-2.1.1 **Equity investments in banking, securities and other financial entities below 20% of the investee's capital must be risk-weighted at a minimum risk-weight of 100% for listed entities and 150% for unlisted entities.**

PCD-2.1.2 **Investments in instruments of a banking, securities and financial entities, other than equity, which are allowed as regulatory capital for the investee must be risk weighted at a minimum risk-weight of 100% for listed instruments or 150% for unlisted instruments unless such investments (including any other equity investment in that entity) exceed 20% of the eligible capital of investee entity, in which case the investments in other regulatory capital instruments of that investee entity must be deducted from the bank's capital for capital adequacy purposes.**

PCD-2.1.3 **If any majority-owned banking, securities and other financial subsidiaries are not consolidated or aggregated for regulatory capital purposes as stated in paragraph PCD-1.1.5 and section PCD-3.1 respectively, all equity and other regulatory capital investments in those entities attributable to the group will be deducted, and the assets and liabilities, as well as third-party capital investments in the subsidiary will be removed from the bank's balance sheet for regulatory capital purposes.**

PCD-2.1.4 **If any significant investments in banking, securities and other financial entities are not prorata-consolidated or prorata-aggregated for regulatory capital purposes as stated in paragraph PCD-1.2.3 and section PCD-3.1 respectively, all equity and other regulatory capital investments in those entities attributable to the group will be deducted, and the assets and liabilities, as well as third-party capital investments in the investee will be removed from the bank's balance sheet for regulatory capital purposes.**

PCD-2.1.5 CBB will ensure these entities (referred to in paragraph PCD-2.1.3 and PCD-2.1.4) otherwise meet regulatory capital requirements and monitor steps taken by the bank to correct any capital shortfall, if it exists. If not corrected within the timeframe agreed with CBB, the shortfall will also be deducted from investor bank's capital for regulatory capital purposes. In case of PCD-2.1.4, this deduction will be on proportionate basis if other parties are also willing to support on proportionate basis.

PCD-2.2 Significant investments in insurance entities

PCD-2.2.1 When measuring regulatory capital for banks, the equity holdings in an insurance entity of 20% or more of the investee's capital shall be required to be deducted from bank's capital for regulatory capital purposes. Holdings less than 20% will be risk weighted under the applicable credit risk weighting rules.

PCD-2.2.2 Majority-owned or controlled insurance subsidiaries must be adequately capitalised to reduce the possibility of future potential losses to the parent bank. The parent bank will monitor actions taken by the subsidiary to correct any capital shortfall and, if it is not corrected in a timely manner, the shortfall will also be deducted from the parent bank's capital for regulatory capital purposes.

PCD-2.3 Significant investments in commercial entities

PCD-2.3.1 Investments in commercial entities include holding of equities of commercial entities acquired through underwriting activities which have been held for more than 90 days[2].

PCD-2.3.2 Significant minority and majority investments in commercial entities which exceed certain materiality levels must be deducted from the bank's capital for regulatory capital purposes. If the investments exceed a materiality level of 15% of the bank's capital on an individual basis, the concerned bank is required to deduct the excess amount from its capital. If the aggregate amount of all investments of 15% or more of the concerned bank's capital exceeds a threshold of 60% of the bank's capital, then such excess amount is also to be deducted from the bank's capital. The application of the materiality levels will be undertaken in the order of deduction of amount in excess of 15% of bank's capital followed by 60% of capital. An illustrative example is provided in Appendix PCD-1.

PCD-2.3.3 Investments in commercial entities below the materiality levels noted herein will be risk-weighted under the applicable risk weighting rules (see chapter CA-5 for trading book and chapter CA-4 for banking book). The risk-weighting treatment will follow the accounting method in the concerned bank's audited financial statements. The effect of banks' existing significant holdings in commercial entities will be reviewed by the CBB subsequent to the completion of initial PIRs. The CBB will then discuss any possible transitional arrangements with concerned banks after initial trial PIRs have been received.

[2] Within the period of 90 days, underwritten amounts can be treated under trading book rules subject to fulfilment of the criteria relating to trading book treatment in accordance with chapter CA-5 of the CA Module. If the criteria are not met, such amounts will be subject to banking book treatment.

PCD-2.4 Common deduction principles

PCD-2.4.1 **Reciprocal cross holdings of banks' capital artificially designed to inflate the capital position of banks must be deducted for regulatory capital purposes. In determining such reciprocal cross-holdings, the CBB will take into account any bilateral agreement, dates and timings of such transactions and the amount of the two transactions involved. This deduction must be made from the tier in which the reciprocal cross holding exists.**

PCD-2.4.2 In case of non-compliance[3] with the large exposure limits (as set out in other modules of the Rulebook), the excess will be deducted from the capital of the bank for regulatory capital purposes. For off-balance sheet items, the excess is to be calculated after the application of credit conversion factors as detailed in chapter CA-4 of the Capital Adequacy Module for Islamic banks. These deduction requirements apply for direct exposures (i.e. funded by a bank's own funds or unrestricted investment accounts) and restricted investment accounts.

PCD-2.4.3 **Deductions referred to in this module (except as stated otherwise, see paragraph PCD-2.4.1, PCD-2.4.4 and PCD-2.4.7) must be made 50% from Tier 1 and 50% from Tier 2 capital. If the amount deductible from Tier 2 exceeds the bank's actual Tier 2, the bank should deduct the shortfall amount from Tier 1 capital.**

PCD-2.4.4 **Goodwill relating to consolidated subsidiaries and entities subject to a deduction approach pursuant to this chapter must be deducted from Tier 1, and the remainder of the investments must be deducted as provided for in this sub-section.**

PCD-2.4.5 The limits on Tier 2 capital will be based on the amount of Tier 1 capital after all deductions. Note that total eligible Tier 2 Capital may not exceed Tier One Capital. See Appendix PCD-2 for details of how these limits work in practice.

PCD-2.4.6 Where the deduction requirement relates to an investment which is carried at fair value and the resultant unrealised fair value gain/loss has been included in Tier 2 capital as per paragraph CA-2.1.5 (e) of the Capital Adequacy Module, the unrealised fair value gain/loss will be removed from the Tier 2 capital. The remaining amount will be deducted as per the above paragraph PCD-2.4.3. If the deduction is not for the full amount of investment, then the related unrealised fair value gain/loss will also be eliminated proportionately from Tier 2 capital. An example is provided in Appendix PCD-2.

PCD-2.4.7 **Positions in the bank's own eligible regulatory capital instruments are deducted from capital. This deduction must be made from the Tier in which the investment exists.**

[3] For the purpose of this rule, non-compliance means where a large exposure is taken without prior approval of CBB.

PCD-2.4 Common deduction principles (continued)

PCD-2.4.8 **This prudential deductions framework (PCD-2.4) applies to investments irrespective of their classification in banking book or trading book. Where a bank demonstrates that it is an active market maker then the CBB may, on a case by case basis, establish a dealer exception for holdings of other designated banks', securities firms', and other financial entities' capital instruments in the trading book. In order to qualify for the dealer exception, the bank must demonstrate to the CBB that it has adequate systems and controls surrounding the trading of financial institutions' eligible regulatory capital instruments.**

PCD-3.1 Related Issues

PCD-3.1.1 If a parent bank either controls or holds a significant investment (20% - 50%) in a non-resident banking, securities or other financial entity which is filing its return with the respective supervisor under the Basel II capital adequacy rules, the investor bank will not automatically be required to consolidate or pro-rata consolidate on a line by line basis respectively for regulatory capital purposes. Under such circumstances, the aggregation rules outlined in paragraph PCD-3.1.2 will be applicable. However, a bank may opt to consolidate or pro-rata consolidate such entities instead of aggregation or pro-rata aggregation provided that it satisfies CBB that these entities are otherwise adequately capitalised on a stand-alone basis in their respective jurisdictions. CBB will liaise with the concerned host supervisors in this regard. In addition, if a foreign branch of a Bahraini bank is filing its return with the respective supervisor under the Basel II capital adequacy rules, the aggregation rules may also be applied to such branch.

PCD-3.1.2 The capital and risk weighted assets (RWAs) of the non-resident entity must be shown separately. The parent bank will be required to aggregate the subsidiary's eligible capital and RWAs (based on the risk weighting of assets reported by the subsidiary to its host central bank) with its own eligible capital and RWAs respectively. In cases where bank does not control the entity, such aggregation will be limited to the percentage of ownership by the bank in the financial entity (see **Appendix PCD-3**). In cases where the bank does control the entity, the bank will be required to undertake full aggregation (see **Appendix PCD-4**).

PCD-3.1.3 Appropriate adjustments will be made to eliminate intra-group exposures.

PCD-3.1.4 If a bank in Bahrain is a subsidiary of a non-resident parent bank, the capital adequacy of such bank will be determined on a standalone basis.

Appendix PCD-1

Investments in commercial entities

Bank "x" with eligible capital of 1,000,000 before deductions has made investment in seven commercial entities listed below:

Investee	Amount	%age of bank's capital
a	100,000	10%
b	120,000	12%
c	150,000	15%
d	160,000	16%
e	170,000	17%
f	200,000	20%
g	250,000	25%
Total	**1,150,000**	**115%**

The amount to be deducted from capital in respect of these investments will be based on the following calculation:

15% threshold (Individual basis)

Sr #	Amount	15% of Bank's capital	Excess over 15% of Bank's capital
d	160,000	150,000	10,000
e	170,000	150,000	20,000
f	200,000	150,000	50,000
g	250,000	150,000	100,000
Total			**180,000**

Capital deduction on account of 15% threshold on individual basis is 180,000 (A).

60% Threshold (Aggregate basis)

Aggregate of investments after 15% deduction:

c	150,000
d	150,000
e	150,000
f	150,000
g	150,000
Total	**750,000 (B)**

60% of Bank's capital = 600,000
Aggregate (B) =750,000
Deduction =150,000

So the capital deduction based on the 60% threshold on aggregate basis is 150,000 (C).

Total deduction based on investments in commercial entities is 330,000 (A+C).

Net eligible capital after deductions is 670,000 (1,000,000 – 330,000).

Remaining amount of investments 820,000 (1,150,000-330,000) will be risk weighted under the applicable risk weighting rules.

Appendix PCD-2

Comprehensive example of deductions

Bank "x" with capital base of 10,000,000 before deductions (consisting of 5,000,000 Tier 1 and 5,000,000 Tier 2) has made four investments listed below along with the amount required to be deducted from the capital for capital adequacy purposes:

Investment	Amount	Deduction requirement (For rules refer to chapter PCD-2)
Bank "a"	1,000,000	1,000,000
Insurance entity "b"	3,000,000	3,000,000 [4]
Commercial entity "c"	2,000,000	500,000 [5]
Entity "d"	500,000	400,000 [6]
Total	6,500,000	4,900,000

Determination of eligible Tier 1 and Tier 2 capital:
These deductions include Goodwill of 100,000 & reciprocal cross holdings of 400,000 in Tier 1.

Determination of eligible capital:

	Tier 1 capital	**Tier 2 capital**
Capital base	5,000,000	5,000,000
Goodwill [7]	(100,000)	-
Reciprocal cross-holding [8]	(400,000)	-
Other deductions (Equally from Tier 1 and Tier 2) (4,900,000 – 500,000=4,400,000/2)	(2,200,000)	(2,200,000)
Resulting capital	2,300,000	2,800,000
Eligible capital	**2,300,000**	**2,300,000** [9]

Calculation of CAR:

$$CAR = \frac{\text{Eligible capital}}{\text{Risk-Weighted Assets}}$$

$$= \frac{(2{,}300{,}000 + 2{,}300{,}000)}{\text{(Say) } 40{,}000{,}000} = \frac{4{,}600{,}000}{40{,}000{,}000} = \mathbf{11.5\%}$$

[4] This investment is 30% of the insurance "b" capital.
[5] This investment is 20% of the bank's capital. As such the amount exceeding 15% i.e. 500,000 will be deducted.
[6] This investment is 2% of entity "d"s capital. Entity "d" has also made investment in Tier 1 capital of Bank "x" amounting to 400,000. This amount (400,000), being cross-holding, is required to be deducted from regulatory capital of the bank "x".
[7] This represents goodwill arising at the time of acquisition of a consolidated subsidiary.
[8] As this cross-holding exists in Tier 1 capital (see footnote 3), this amount must be deducted from the same tier.
[9] Tier 2 can not exceed 100% of Tier 1 (after all subsequent deductions).

Appendix PCD-3

Pro-rata aggregation

Bank "x" has made an investment in a non-resident financial entity "y" (30% shareholding) which is filing its return with the respective supervisor under the Basel II capital adequacy rules. The aggregation of capital and RWAs will be carried out as follows:

Bank:

Eligible regulatory capital = 3,000,000[10]
Risk weighted assets = 20,000,000

CAR = 3,000,000 / 20,000,000

= 15%

Investee:

Eligible regulatory capital = 1,000,000
Risk weighted assets = 10,000,000

CAR = 1,000,000 / 10,000,000

= 10%

Consolidated Capital Adequacy Ratio:

Eligible regulatory capital = 3,300,000 [(3,000,000 + (1,000,000*30%)]
Risk weighted assets = 23,000,000 (20,000,000 + (10,000,000*30%)]

CAR = 3,300,000 / 23,000,000

= 14.35%

[10] This capital amount is after all necessary deductions, including investment in "y".

Appendix PCD-4

Full aggregation

Bank "x" controls a non-resident financial entity "z" (80% shareholding) which is filing its return with the respective supervisor under the Basel II capital adequacy rules. The aggregation of capital and RWAs will be carried out as follows:

Parent Bank:

Eligible regulatory capital = 3,000,000[11]
Risk weighted assets = 20,000,000

$$CAR = \frac{3,000,000}{20,000,000}$$

= 15%

Non-resident subsidiary:

Eligible regulatory capital = 1,000,000
Risk weighted assets = 10,000,000

$$CAR = \frac{1,000,000}{10,000,000}$$

= 10%

Consolidated Capital Adequacy Ratio:

Eligible regulatory capital = 4,000,000 (3,000,000+1,000,000)
Risk weighted assets = 30,000,000 (20,000,000+10,000,000)

$$CAR = \frac{4,000,000}{30,000,000}$$

= 13.33%

[11] This capital amount is after all necessary deductions, including investment in "z".

Appendix PCD-5

Calculation of the investment amount, based on its fair value that should be deducted from capital base

Bank "x" with eligible capital of 1,000 before deductions has made investment in a commercial entity (cost 160) which is carried at fair value (200). The amount to be deducted is as follows:

Regulatory capital (before deductions) = 1,000

Equity investment at cost = 160

Equity investment at fair value = 200

Fair value gain = 40

Amount to be subjected to deduction (see Appendix CA-17 of CA module) = 200 – (40*.55) = 178

Excess investment amount above the 15% level = 178 – (1,000 X 0.15) = 28

The deduction should be as follows:

1. The asset side should be reduced by 50 (28 see above + 22 see Appendix CA-17 of CA Module)
2. The Capital Base shall be reduced as follows:

Fair value to be removed from Tier 2 (18/178*28)	2.82
Deduction of 50% of remaining amount from Tier 1 (28-2.83 = 25.17/2)	12.59
Deduction of 50% of the remaining amount from Tier 2 (28-2.83 = 25.17/2)	12.59
Total deduction from capital base	28.00