



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.1 Application

CA-A.1.1 Rules in this Module are applicable to locally incorporated banks (hereinafter referred to as “the banks”) on both a stand-alone (i.e. including their foreign branches) and on a consolidated group basis (i.e. including their subsidiaries and any other investments which are included or consolidated into the group accounts or which are required to be consolidated or aggregated for regulatory purposes by the Central Bank of Bahrain (‘CBB’).

CA-A.1.2 If the banks have investments in banking, securities, financial, insurance and/or commercial entities, the banks will also need to apply rules set out in the Prudential Consolidation and Deduction Requirements Module (Module PCD) for the calculation of their solo and consolidated Capital Adequacy Ratio (CAR).

CA-A.1.3 Certain of the requirements relating to gearing (See Chapter CA-15) also apply to Bahrain branches of foreign retail bank licensees.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.2 Purpose

Executive Summary

CA-A.2.1 The purpose of this module is to set out the CBB's capital adequacy Rules and provide guidance on the risk measurements for the calculation of capital requirements by locally incorporated banks. This requirement is supported by Article 44(c) of the Central Bank of Bahrain and Financial Institutions Law (Decree No. 64 of 2006).

CA-A.2.2 Principle 9 of the Principles of Business requires that conventional bank licensees maintain adequate human, financial and other resources, sufficient to run their business in an orderly manner (see Section PB-1.9). In addition, Condition 5 of CBB's Licensing Conditions (Section LR-2.5) requires conventional bank licensees to maintain financial resources in excess of the minimum requirements specified in Module CA (Capital Adequacy).

CA-A.2.3 This Module also sets out the minimum gearing requirements which relevant banks (referred to in Section CA-A.1) must meet as a condition of their licensing.

CA-A.2.4 The requirements specified in this Module vary according to the Category of conventional bank licensee concerned, their inherent risk profile, and the volume and type of business undertaken. The purpose of such requirements is to ensure that conventional bank licensees hold sufficient capital to provide some protection against unexpected losses, and otherwise allow conventional banks to effect an orderly wind-down of their operations, without loss to their depositors. The minimum capital requirements specified here may not be sufficient to absorb all unexpected losses.

CA-A.2.5

The CBB requires in particular that the relevant banks maintain adequate capital, in accordance with the requirements of this Module, against their risks.

CA-A.2.6 This module provides support for certain other parts of the Rulebook, mainly:

- (a) Prudential Consolidation and Deduction Requirements;
- (b) Licensing and Authorisation Requirements;
- (c) CBB Reporting Requirements;
- (d) Credit Risk Management;
- (e) Operational Risk Management;
- (f) High Level Controls;
- (g) Relationship with Audit Firms; and
- (h) Penalties and Fines.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.2 Purpose (continued)

Legal Basis

CA-A.2.7

This Module contains the CBB's Directive (as amended from time to time) relating to the capital adequacy of conventional bank licensees, and is issued under the powers available to the CBB under Article 38 of the CBB Law. The Directive in this Module is applicable to all conventional bank licensees.

CA-A.2.8

For an explanation of the CBB's rule-making powers and different regulatory instruments, see Section UG-1.1.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.3 Capital Adequacy Ratio

CA-A.3.1 Historically, on a consolidated basis, the CBB has set a minimum Capital Adequacy Ratio ("CAR") of 12.0% for all locally incorporated banks. Furthermore, on a solo basis, the parent bank has been required to maintain a minimum CAR of 8.0% (i.e. unconsolidated). The arrangements outlined below will apply once banks have been subject to a Pillar 2 risk profile assessment by the CBB or an acceptable audit firm. Until such an assessment has been completed, the existing 12% and 8% minimum capital ratio requirements (as outlined in Module CA-2.5 October 2006 edition) will remain in place.

CA-A.3.2 CAR is calculated by applying the regulatory capital to the numerator and risk-weighted assets to the denominator.

CA-A.3.3 All locally incorporated banks are required to maintain a capital ratio both on a solo (and a consolidated basis where applicable) above the minimum "trigger" CAR of 8%. Failure to remain above the trigger ratio will result in Enforcement and other measures as outlined in Section CA-1.4.

CA-A.3.4 All locally incorporated banks will be required to maintain capital ratios above individually set "target" CARs on a solo and on a consolidated basis. These target CARs will be set at an initial minimum of 8.5% and may in the case of high risk banks be set at levels above the 12.5% target ratio set prior to January 2008. Failure to remain above the target ratio will result in Enforcement and other measures as outlined in Section CA-1.4.

Eligible Capital

CA-A.3.5 Banks are allowed three classes of capital (see section CA- 2.1) to meet their capital requirements for credit, operational and market risk, as set out below:

- Tier 1:** Core capital – May be used to support credit, operational and market risk
- Tier 2:** Supplementary capital – May be used to support credit, operational and market risk; and
- Tier 3:** Ancillary capital – May be used solely to support market risk.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.3 Capital Adequacy Ratio (continued)

Risk-weighted Assets

CA-A.3.6

Total risk-weighted assets are determined by:

- (a) Multiplying the capital requirements for market risk and operational risk by 12.5; and
- (b) Adding the resulting figures to the sum of risk-weighted assets for credit risk.

CA-A.3.7

For the measurement of their credit risks, banks have a choice, subject to the written approval of the CBB, between two broad methodologies:

- (a) One alternative is to measure the risks in a standardised approach, applying the measurement framework described in Chapter CA-3 of this Module; and
- (b) The second methodology (i.e. internal ratings-based approach) is set out in detail in Chapter CA-5 including the procedure for obtaining the CBB's approval. This methodology is subject to the fulfilment of certain conditions. The use of this methodology is, therefore, conditional upon the explicit approval of the CBB.

CA-A.3.8

Credit risk – Securitization framework is set out in Chapter CA-6. Banks must apply the securitisation framework for determining regulatory capital requirements on exposures arising from traditional and synthetic securitisations or similar structures that contain features common to both.

CA-A.3.9

For the measurement of their operational risks, banks have a choice, subject to the written approval of the CBB, between two broad methodologies:

- (a) One alternative is to measure the risks in a basic indicator approach, applying the measurement framework described in Chapter CA-7 of this Module; and
- (b) The second alternative methodology (i.e. the standardised approach) is set out in detail in Chapter CA-7 including the procedure for obtaining the CBB's approval. This methodology is subject to the fulfilment of certain conditions (as outlined in Module OM). The use of this methodology is, therefore, conditional upon the explicit approval of the CBB.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.3 Capital Adequacy Ratio (continued)

CA-A.3.10

For the measurement of their market risk, banks have a choice, subject to the written approval of the CBB, between two broad methodologies:

- (a) One alternative is to measure the risks in a standardised approach, applying the measurement frameworks described in Chapters CA-9 to CA-13 of this Module; and
- (b) The second alternative methodology (i.e. the internal models approach) is set out in detail in Chapter CA-14 including the procedure for obtaining the CBB's approval. This methodology is subject to the fulfilment of certain conditions. The use of this methodology is, therefore, conditional upon the explicit approval of the CBB.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.4 Transitional Arrangements

CA-A.4.1 For banks applying the IRB approach for credit risk, there will be a capital floor following implementation of this Module. Banks must calculate the difference between: (i) the floor as defined in Paragraph CA-A.4.2 and (ii) the amount as calculated according to Paragraph CA-A.4.3. If the floor amount is larger, banks are required to add 12.5 times the difference to the risk-weighted assets.

CA-A.4.2 The capital floor is based on previous capital adequacy Rules issued by CBB dated July 2004. It is derived by applying an adjustment factor to the following amount: (i) 8% of the risk-weighted assets, (ii) plus Tier 1 and Tier 2 deductions, (iii) less that amount of incurred loss provisions that may be recognised in Tier 2. The adjustment factor for banks applying the foundation IRB approach for the year 2008 is 95%. The adjustment factor for the year 2009 is 90%, and for the year 2010 is 80%. The following table illustrates the application of the adjustment factors. Additional transitional arrangements including parallel calculation are set out in Paragraphs CA-5.2.45 to CA-5.2.51.

	2008	2009	2010
Foundation IRB approach	95%	90%	80%

CA-A.4.3 In the years in which the floor applies, banks must also calculate (i) 8% of total risk-weighted assets as calculated under this Module, (ii) less the difference between total provisions and expected loss amount as described in Section CA-5.7, and (iii) plus other Tier 1 and Tier 2 deductions.

CA-A.4.4 These prudential floors are also applicable to banks that do not complete the transition to IRB approach in the years specified in Paragraph CA-2.4.2 to provide time to ensure that individual bank implementations of the IRB approach are sound. However, CBB may develop appropriate bank-by-bank floors periodically.

CA-A.4.5 Banks which start to use internal models for market risk for one or more risk categories should, over a reasonable period of time, extend the models to all of their operations, subject to the exceptions mentioned in Paragraph CA-A.4.6 below, and move towards a comprehensive model (i.e., one which captures all market risk categories).



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.4 Transitional Arrangements (continued)

CA-A.4.6

On a transitional basis, banks will be allowed to use a combination of the standardised approach and the internal models approach to measure their market risks provided they should cover a complete risk category (e.g., interest rate risk or foreign exchange risk), i.e., a combination of the two methods will not be allowed within the same risk category¹. However, banks presently implementing or further improving their internal models will be allowed some flexibility (including within risk categories) in including all their operations on a worldwide basis. This flexibility shall be subject to the specific prior written approval of the CBB, and such approval will be given on a case-by-case basis and reviewed by the CBB from time to time.

CA-A.4.7

The CBB will closely monitor banks to ensure that there will be no "cherry-picking" between the standardised approach and the models approach for market risk within a risk category. Banks which adopt a model will not be permitted, save in exceptional circumstances, to revert to the standardised approach.

CA-A.4.8

The CBB recognises that even a bank which uses a comprehensive model for market risk may still incur risks in positions which are not captured by their internal models², for example, in remote locations, in minor currencies or in negligible business areas³. Any such risks that are not included in a model should be separately measured and reported using the standardised approach described in Chapters CA-9 to CA-13.

CA-A.4.9

Transitioning banks are required to move towards a comprehensive internal model approach for market risk.

CA-A.4.10

The CBB will closely monitor the risk management practices of banks moving towards the models approach for market risk, to ensure that they are in a position to meet all standards once they apply a full-fledged model for any risk category.

¹ This does not, however, apply to pre-processing techniques which are used to simplify the calculation and whose results become subject to the standardised methodology.

² Banks may also incur interest rate and equity risks outside of their trading activities. However, there are no explicit capital charges for the price risk in such positions.

³ For example, if a bank is hardly at all engaged in commodities it will not necessarily be expected to model its commodities risk.



MODULE	CA: Capital Adequacy
CHAPTER	CA-A: Introduction

CA-A.5 Module History

CA-A.5.1 This module was first issued in July 2004 as part of the conventional principles volume. Any material changes that have subsequently been made to this module are annotated with the calendar quarter date in which the changes were made. Chapter UG-3 provides further guidance on Rulebook maintenance and version control.

CA-A.5.1A The most recent changes are detailed in the Table below.

Summary of Changes

Module Ref.	Change Date	Description of Changes
CA-A.2	10/07	Change categorising Module as a Directive
CA-1 to CA-8	01/08	Extensive changes to implement Basel II
CA-3.4	04/08	Recognition and mapping of grades for Capital Intelligence
CA-3.2.15-18	01/09	New guidance and rules on SMEs
CA-A	01/2011	Various minor amendments to ensure consistency in CBB Rulebook.
CA-A.2.7	01/2011	Clarified legal basis.

Evolution of Module

CA-A.5.2 Prior to the development of this Module, the CBB had issued various circulars representing regulations relating to capital adequacy requirements. These circulars and their incorporation into this module are listed below:

Circular Ref.	Date of Issue	Module Ref.	Circular Subject
ODG/50/98	11 Sep 1998	CA 8 – CA 14	Market Risk Capital Regulations
BC/07/02	26 Jun 2002	CA 1.5	Review of PIR by External Auditors
OG/78/01	20 Feb 2001	CA-A.3 & CA-1.4	Monitoring of Capital Adequacy
BC/01/98	10 Jan 1998	CA-A.3 & CA-1.4	Capital Adequacy Ratio

CA-A.5.3

The contents retained from the previous Module (Capital Adequacy – Conventional Banks) are effective from the date depicted in the above circulars (see Paragraph CA-A.5.2) or from the dates mentioned in the Summary of Changes. The remainder of the updated Module is effective from January 01, 2008.



MODULE	CA: Capital Adequacy
CHAPTER	CA-1: Scope and Coverage of Capital Charges

CA-1.1 Application

CA-1.1.1 All locally incorporated banks are required to measure and apply capital charges with respect to their credit, operational and market risks capital requirements.

CA-1.1.2 Credit risk is defined as the potential that a bank's borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Credit risk exists throughout the activities of a bank in the banking book and in the trading book and includes both on- and off-balance-sheet exposures.

CA-1.1.3 Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk,² but excludes strategic and reputational risk.

CA-1.1.4 Market risk is defined as the risk of loss in on- or off-balance-sheet positions arising from movements in market prices. The risks subject to the capital requirement of this module are:

- (a) The risks pertaining to interest rate related instruments and equities in the trading book; and
- (b) Foreign exchange and commodities risks throughout the bank.

² Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.



MODULE	CA: Capital Adequacy
CHAPTER	CA-1: Scope and Coverage of Capital Charges

CA-1.2 Monitoring of Risks

CA-1.2.1

Banks are required to manage their risks, especially market risk, in such a way that the capital requirements are being met on a continuous basis, i.e. at the close of each business day and not merely at the end of each calendar quarter. Banks are also required to maintain strict risk management systems to ensure that their intra-day exposures are not excessive.

CA-1.2.2

Banks' daily compliance with the capital requirements for credit and market risk must be verified by the independent risk management department and the internal auditor. It is expected that the external auditors will perform appropriate tests of the banks' daily compliance with the capital requirements for credit and market risk. Where a bank fails to meet the minimum capital requirements for credit and market risk on any business day, the CBB must be informed in writing by no later than the following business day. The CBB will then seek to ensure that the bank takes immediate measures to rectify the situation.



MODULE	CA: Capital Adequacy
CHAPTER	CA-1: Scope and Coverage of Capital Charges

CA-1.3 Investments in other Entities and Consolidation

CA-1.3.1

The banks must also apply rules set in the Prudential Consolidation and Deduction Requirements Module where the bank has significant investments (as defined in the aforementioned Module) in other entities.

CA-1.3.2

These capital adequacy regulations must be applied on a worldwide consolidated basis as well as on a solo basis. Guidance on consolidation and related matters is provided in the Prudential Consolidation and Deduction Requirements Module.



MODULE	CA: Capital Adequacy
CHAPTER	CA-1: Scope and Coverage of Capital Charges

CA-1.4 Reporting

CA-1.4.1 Formal reporting, to the CBB, of capital adequacy must be made in accordance with the requirements set out under section BR 3.1.

CA-1.4.2 Where a bank's CAR falls below its individual target ratio either on a solo basis (or on a consolidated basis), the General Manager of the bank must notify the CBB by the following business day, however no formal action plan will be necessary. The General Manager must explain what measures are being implemented to ensure that the bank will remain above its minimum target CAR(s).

CA-1.4.3 The bank will be required to submit form PIR (and PIRC where applicable) to the CBB on a monthly basis, until the concerned CAR exceeds its target ratio.

CA-1.4.4 The CBB will notify banks in writing of any action required of them with regard to the corrective and preventive action (as appropriate) proposed by the bank pursuant to the above, as well as of any other requirement of the CBB in any particular case.

CA-1.4.5 All locally incorporated banks must provide the CBB, with immediate written notification (i.e. by no later than the following business day) of any actual breach of the minimum trigger CAR of 8%. Where such notification is given, the bank must also provide the CBB:

- (a) No later than one calendar week after the notification, with a written action plan setting out how the bank proposes to restore the relevant CAR(s) to the required minimum level(s) set out above and, further, describing how the bank will ensure that a breach of such CAR(s) will not occur again in the future; and
- (b) Report on a weekly basis thereafter on the bank's relevant CAR(s) until such CAR(s) have reached the required target level(s) described above.

CA-1.4.6 Banks must note that the CBB considers the breach of CARs to be a very serious matter. Consequently, the CBB may (at its discretion) subject a bank which breaches its CAR(s) to a formal licensing reappraisal. Such reappraisal may be effected either through the CBB's own inspection function or through the use of Reporting Accountants, as appropriate. Following such appraisal, the CBB will notify the bank concerned in writing of its conclusions with regard to the continued licensing of the bank.

CA-1.4.7 The CBB recommends that the bank's compliance officer support and cooperate with the CBB in the monitoring and reporting of the CARs and other regulatory reporting matters. Compliance officers should ensure that their banks have adequate internal systems and controls to comply with these regulations.



MODULE	CA: Capital Adequacy
CHAPTER	CA-1: Scope and Coverage of Capital Charges

CA-1.5 Review of Prudential Information Returns by External Auditors

- CA-1.5.1 The CBB requires all relevant banks to request their external auditors to conduct a review of the prudential returns on a quarterly basis in accordance with the requirements set out under section BR 3.1. However, if a bank provides prudential returns without any reservation from auditors for two consecutive quarters, it can apply for exemption from such review for a period to be decided by CBB.



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.1 Regulatory Capital

Tier 1: Core Capital

CA-2.1.1

Tier 1 capital shall consist of the sum of items (a) to (f) below, less the sum of items (g) to (k) below:

- (a) Issued and fully paid ordinary shares and perpetual non-cumulative preference shares, but excluding cumulative preference shares;
- (b) Certain innovative capital instruments such as instruments with step-ups, subject to the fulfilment of criteria given in paragraph CA-2.1.2 to CA-2.1.4 and the limit given in paragraph CA-2.2.2.
- (c) Disclosed reserves, including:
 - General reserves
 - Legal / statutory reserves
 - Share premium
 - Capital redemption reserve
 - Excluding fair value reserves³
- (d) Retained profit brought forward;
- (e) Unrealized net gains arising from fair valuing equities⁴; and
- (f) Minority interest in subsidiaries Tier 1 equity. arising on consolidation, in the equity of subsidiaries which are less than wholly owned. Further guidance on minority interests is provided in paragraphs PCD-A.2.11, PCD-1.1.3 and PCD-1.1.4 of the Prudential Consolidation and Deduction Requirements Module.

LESS:

- (g) Goodwill;
- (h) Current interim cumulative net losses;
- (i) Unrealized gross losses arising from fair valuing equity securities⁵;
- (j) Other deductions made on a pro-rata basis between Tier 1 and Tier 2;
- (k) Reciprocal cross holdings of other banks' capital.

³ This refers to unrealised fair value gains reported directly in equity (such gross gains are included in Tier 2).

⁴ This refers to unrealised net fair value gains taken through P&L (which have been audited). Please note that the unrealised net gains related to unlisted equities taken through P&L arising on or after January 1, 2008 will be subject to 55% discount as stated in CA-2.1.5(c)ii.

⁵ This refers to both 'net losses taken through P&L' and 'gross losses reported directly in equity'.



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.1 Regulatory Capital (continued)

CA-2.1.2 Certain innovative capital instruments agreed to on a case by case basis by CBB, where the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by all instruments in Tier 1:

- (a) Issued and fully paid;
- (b) Non-cumulative;
- (c) Able to absorb losses within the bank on a going-concern basis;
- (d) Junior to depositors, general creditors, and subordinated debt of the bank;
- (e) Permanent;
- (f) Neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors;
- (g) Callable at the initiative of the issuer only after a minimum of five years, with CBB approval and under the condition that it will be replaced with capital of same or better quality, unless the CBB determines that the bank has capital that is more than adequate to cover its risks.
- (h) The main features of such instruments must be easily understood and publicly disclosed;
- (i) Proceeds must be immediately available without limitation to the issuing bank;
- (j) The bank must have discretion over the amount and timing of distributions, subject only to prior waiver of distributions on the bank's common stock, and banks must have full access to waived payments; and
- (k) Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.

CA-2.1.3 Moderate step-ups in such instruments meeting the requirements set forth above, are permitted, in conjunction with a call option, only if the moderate step-up occurs at a minimum of ten years after the issue date and if it results in an increase over the initial rate that is no greater than either;

- (a) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
- (b) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.

CA-2.1.4 The terms of the instrument should provide for no more than one rate step-up over the life of the instrument. The swap spread should be fixed as of the pricing date and reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.1 Regulatory Capital (continued)

Tier 2: Supplementary Capital

CA-2.1.5

Tier 2 capital shall consist of the following items:

- (a) Current interim profits which have been reviewed as per the IAS by the external auditors;
- (b) Asset revaluation reserves which arise from the revaluation of fixed assets from time to time in line with the change in market values, and are reflected on the face of the balance sheet as a revaluation reserve. Similarly, gains may also arise from revaluation of Investment Properties (real estate). These reserves (including the net gains on investment properties) may be included in Tier 2 capital, with the concurrence of the external auditors, provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale. A discount of 55% must be applied to the difference between the historical cost book value and the market value to reflect the potential volatility of this form of unrealised capital.
- (c) Unrealized gains arising from fair valuing equities:
 - (i) For unrealized gross gains reported directly in equity, a discount factor of 55% will be applied before inclusion in Tier 2 capital. Note for gross losses, the whole amount of such loss should be deducted from the Tier 1 capital.
 - (ii) For unrealized net gains reported in income, a discount factor of 55% will apply on any such unrealized net gains from unlisted equity instruments before inclusion in Tier 1 capital (for audited gains) or Tier 2 capital (for reviewed gains) as appropriate. This discount factor will be applied to the incremental net gains related to unlisted equities arising on or after January 1, 2008.
- (d) Banks should note that the Central Bank will discuss the applicability of the discount factor under paragraph © above with individual banks. This discount factor relating to CA-2.1.5©ii may be reassessed by the CBB if the bank arranges an independent review (which has been performed for the bank's systems and controls relating to FV gains on financial instruments) and meets all the requirements of the paper '*Supervisory guidance on the use of the fair value option for financial instruments by banks*' issued by Basel Committee on Banking Supervision in June 2006;



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.1 Regulatory Capital (continued)

- (e) Banks applying the IRB approach for securitisation exposures or the PD/LGD approach for equity exposures must first deduct the expected loss (EL) amounts subject to the corresponding conditions in paragraphs CA-6.4.4 and CA-5.7.13, respectively. Banks applying the IRB approach for other asset classes must compare (i) the amount of total eligible provisions, as defined in paragraph CA-5.7.7, with (ii) the total expected losses amount as calculated within the IRB approach and defined in paragraph CA-5.7.2. Where the total expected loss amount exceeds total eligible provisions, banks must deduct the difference. Deduction must be on the basis of 50% from Tier 1 and 50% from Tier 2. Where the total expected loss amount is less than total eligible provisions, as explained in paragraphs CA-5.7.7 to CA-5.7.10, banks may recognise the difference in Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets. The provisions in excess of 0.6% of credit risk-weighted assets will be deducted from the risk-weighted assets of the related portfolio to which these provisions relate;
- (f) Hybrid instruments, which include a range of instruments that combine characteristics of equity capital and debt, and which meet the following requirements:
- They are unsecured, subordinated and fully paid-up;
 - They are not redeemable at the initiative of the holder or without the prior consent of the CBB;
 - They are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt); and
 - Although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with cumulative preference shares) where the profitability of the bank would not support payment. Cumulative preference shares, having the above characteristics, would be eligible for inclusion in Tier 2 capital. Debt capital instruments which do not meet the above criteria may be eligible for inclusion in item (g).



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.1 Regulatory Capital (continued)

- (g) Subordinated term debt, which comprises all conventional unsecured borrowing subordinated (with respect to both interest and principal) to all other liabilities of the bank except the share capital and limited life redeemable preference shares. To be eligible for inclusion in Tier 2 capital, subordinated debt capital instruments should have a minimum original fixed term to maturity of over five years. During the last five years to maturity, a cumulative discount (or amortisation) factor of 20% per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength. Unlike instruments included in item (f) above, these instruments are not normally available to participate in the losses of a bank which continues trading. For this reason, these instruments will be limited to a maximum of 50% of Tier 1 capital. Subordinated debt instruments must also satisfy the conditions outlined in paragraphs CA-2.1.2 (a), (f), (h), (i), (j), CA-2.1.3 and CA-2.1.4. Further, the subordinated debt is only callable before maturity by the issuer with CBB approval, and there must be a clear statement to this effect in the documentation.

Tier 3: Market Risk Ancillary Capital

CA-2.1.6

Tier 3 capital will consist of short-term subordinated debt which, if circumstances demand, must be capable of becoming part of the bank's permanent capital and thus be available to absorb losses in the event of insolvency. It must therefore, at a minimum, meet the following conditions:

- Be unsecured, subordinated and fully paid up;
- Have an original maturity of at least two years;
- Not be repayable before the agreed repayment date; and
- Be subject to a lock-in clause which stipulates that neither interest nor principal may be paid (even at maturity) if such payment means that the bank falls below or remains below its minimum capital requirement.



MODULE	CA: Capital Adequacy
CHAPTER	CA-2: Regulatory Capital

CA-2.2 Limits on the Use of Different Forms of Capital

Tier 1: Core Capital

CA-2.2.1

Tier 1 capital must represent at least half of the total eligible capital after all adjustments to all elements of capital, have been made. i.e., the sum total of Tier 2 plus Tier 3 eligible capital must not exceed total Tier 1 eligible capital.

CA-2.2.2

The CBB expects banks to meet the minimum CARs without undue reliance on innovative instruments, including instruments that have a step-up. Accordingly, the aggregate of issuances of non-common equity Tier 1 instruments with any explicit feature, (other than a pure call option), which might lead to the instrument being redeemed is limited (at issuance) to 15% of the consolidated bank's Tier 1 capital.

CA-2.2.3

The limits on innovative Tier 1 instruments and Tier 2 subordinated debt are based on the amount of Tier 1 capital after deduction of goodwill pursuant to the Prudential Consolidation and Deduction Requirements Module (see **Appendix CA-1** for an example how to calculate the 15% limit for innovative Tier 1 instruments and Appendix PCD-2 of PCD module for an example of the deduction effects and the caps).

Tier 2: Supplementary Capital

CA-2.2.4

Tier 2 elements may be substituted for Tier 3 up to the Tier 3 limit of 250% of Tier 1 capital (as below) in so far as eligible Tier 2 capital does not exceed total Tier 1 capital, and long-term subordinated debt does not exceed 50% of Tier 1 capital after deduction of goodwill.

Tier 3: Ancillary Capital

CA-2.2.5

Tier 3 capital is limited to 250% of a bank's Tier 1 capital that is required to support market risks. This means that a minimum of about 28.57% of market risks needs to be supported by Tier 1 capital that is not required to support risks in the remainder of the book.

CA-2.2.6

Banks are entitled to use Tier 3 capital solely to support market risks as defined in chapters CA-9 to CA-14. This means that any capital requirement arising in respect of credit and counterparty risk, including the credit counterparty risk in respect of derivatives in both trading and banking books, needs to be met by Tier 1 and Tier 2 capital.