



PRUDENTIAL CONSOLIDATION AND DEDUCTION REQUIREMENTS



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| MODULE: | PCD (Prudential Consolidation and Deduction Requirements) |
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| CHAPTER | PCD-A: | Introduction |

PCD-A.1 Purpose

Executive Summary

- 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 (including qualifying holdings). 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 the Central Bank of Bahrain (‘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, the 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 Modules CA and CM, which respectively set minimum capital requirements and large exposure requirements for licensed banks in Bahrain.

Legal Basis

- PCD-A.1.7** This Module contains the CBB’s Directive (as amended from time to time) on prudential consolidation and deduction requirements for conventional bank licensees, and is issued under the powers available to the CBB under Article 38 of the Central Bank of Bahrain of Bahrain and Financial Institutions Law 2006 (CBB Law). The directive in this Module is applicable to all conventional bank licensees.
- PCD-A.1.8 For an explanation of the CBB’s rule-making powers and different regulatory instruments, see Section UG-1.1.



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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 power:

- (a) Over more than half of the voting rights by virtue of an agreement (whether revocable or not) with other investors;
- (b) To govern the financial and operating policies of the entity under a statute or an agreement;
- (c) 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) 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, debt or 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.



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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 investments in:

- (a) Licensed banking, securities¹ or other financial entities from 20% to 50% of the investee's capital;
- (b) Insurance entities of 20% or more of the investee's capital; and
- (c) 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.

PCD-A.2.13

A “qualifying holding” is defined as (see Section CM-5.5 for associated terms) as any investment in the capital instruments of another entity by a locally incorporated bank which is equivalent to or more than 10% of the locally incorporated bank's capital base (as reported in the most recent PIR submitted to the CBB).

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



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PCD-A.3 Module History

PCD-A.3.1 This module was first issued in January 2008 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 change was made: Chapter UG-3 provides further details on Rulebook maintenance and version control.

PCD-A.3.2 A list of recent changes made to this Module is detailed in the table below:

| Module Ref. | Change Date | Description of Changes |
|----------------------------|-------------|---|
| PCD-2.1 | 01/2009 | Clarification on risk weighting of listed and unlisted instruments |
| PCD | 10/2010 | Various minor amendments to ensure consistency in CBB Rulebook. |
| PCD-4 | 10/2010 | New Chapter on SPV moved from Section HC-1.5 |
| PCD-A.1.7 and A.1.8 | 01/2011 | Added legal basis. |
| PCD-A, PCD-2, PCD-3, PCD-4 | 01/2011 | Changes made to incorporate Basel Core principle 5. |
| PCD-A.2.13 | 10/2012 | Amended definition of 'qualifying holding' to be in line with Paragraph CM-5.5.1E and Glossary. |

Effective Date

PCD-A.3.3

The contents of this Module are effective from January 2008 or the dates given in the summary of changes table above.



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| MODULE | PCD: | Prudential Consolidation and Deduction Requirements |
| CHAPTER | PCD-1: | Prudential Consolidation Framework |

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 previously contracted debt or 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.



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| CHAPTER | PCD-1: | Prudential Consolidation Framework |

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 or convertible debt 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).



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| CHAPTER | PCD-1: Prudential Consolidation Framework |

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 previously contracted debt or 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 or convertible debt 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.



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| CHAPTER | PCD-2: | Prudential Deductions Framework |

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 (see CM-5.10 where an investment below 20% of the investee's capital may exceed 15% of the reporting bank's capital base – "Qualifying holdings" – the excess of such individual holdings must be deducted and there is an additional aggregate limit for such holdings).

PCD-2.1.2

Investments in instruments (e.g. sub-ordinated debt) 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.



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| MODULE | PCD: | Prudential Consolidation and Deduction Requirements |
| CHAPTER | PCD-2: | Prudential Deductions Framework |

PCD-2.1 Investments in Banking, Securities and other Financial Entities (continued)

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.



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| CHAPTER | PCD-2: | Prudential Deductions Framework |

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 (or subject to the qualifying holdings requirements outlined in Module CM-5.10).

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.



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| MODULE | PCD: | Prudential Consolidation and Deduction Requirements |
| CHAPTER | PCD-2: | Prudential Deductions Framework |

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.¹

PCD-2.3.2

“Qualifying holdings” in commercial entities which exceed certain materiality levels outlined in CM-5.10 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 qualifying holdings 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 level of a qualifying holding will be risk-weighted under the applicable risk weighting rules (see chapter CA-10 and 14 for trading book and chapter CA-3 and CA-5 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 qualifying holdings will be reviewed by the CBB. The CBB will then discuss any possible transitional arrangements with concerned banks.

¹ Within the period of 90 days, CBB approved underwritten amounts are subject to treatment outlined in Section CM-5.6. See also Chapter CA-8 if such positions are to be included in the trading book.



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| CHAPTER | PCD-2: | Prudential Deductions Framework |

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-compliance¹ with the large exposure limits (as set out in Chapter CM-5 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-3 of the Capital Adequacy Module for conventional banks.

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 issuable subordinated Tier 2 and Tier 3 capital and on innovative Tier 1 instruments will be based on the amount of Tier 1 capital after deduction of goodwill. 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.

¹ For the purpose of this rule, non-compliance means where a large exposure is taken without prior approval of CBB.



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| CHAPTER | PCD-2: | Prudential Deductions Framework |

PCD-2.4 Common Deduction Principles (continued)

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.

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.



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| MODULE | PCD: | Prudential Consolidation and Deduction Requirements |
| CHAPTER | PCD-3: | Related Issues |

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, and the investment is not deducted, 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 If a conventional bank controls or holds significant investment (20% - 50%) in an Islamic bank or Islamic financial entity incorporated in the Kingdom of Bahrain and the investment is not deducted, the capital and RWAs of the Islamic financial entity must be shown separately and measured using the CBB guidelines for Islamic banks. The conventional 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 CBB) with its own eligible capital and RWAs respectively. In cases where the bank does not control the Islamic financial entity, such aggregation will be limited to the percentage of ownership by the bank in the Islamic financial entity. In cases where the bank does control the Islamic financial entity, the bank will be required to undertake full aggregation.
- PCD-3.1.4 If a conventional bank operates an Islamic window, the assets of such Islamic window will be risk weighted in accordance with CBB's guidelines for conventional banks.
- PCD-3.1.5 Appropriate adjustments will be made to eliminate intra-group exposures.
- PCD-3.1.6 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.



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| CHAPTER | PCD-4: | Special Purpose Vehicles ('SPVs') |

PCD-4.1 General Requirements

PCD-4.1.1

All locally incorporated banks must obtain the CBB's prior specific written approval before establishing any subsidiaries (including SPVs where the bank exercises a majority shareholding or has majority voting control by virtue of direct ownership or by proxy/nominee arrangements), branches and/or representative offices, either inside or outside of Bahrain. SPVs are subject to the consolidation, deduction, risk weighting and qualifying holdings rules and regulations mentioned in this Module and Chapter CM-5. In order to avoid any delays and/or disruption in implementation of banks' plans in this context, the CBB should be approached as soon as possible, even at a very preliminary stage.

PCD-4.1.2

All locally incorporated banks must notify the CBB if they intend to act as sponsor or manager of a special purpose vehicle ('SPV'), or if they intend to participate in the creation of an SPV, or if they intend to acquire shares in an SPV. All locally incorporated banks must notify the CBB if they are appointed as nominee shareholders of SPVs or hold votes by proxy arrangement in SPVs on behalf of other investors. In all cases noted in this Paragraph, the concerned bank must notify the CBB quarterly of any new commitments to, or engagements in business arrangements with SPVs. These reporting and notification arrangements apply in addition to arrangements under Paragraph PCD-4.1.1 where the SPV is a subsidiary.

PCD-4.1.3

The CBB requires any locally incorporated bank associated with an SPV to give the background to the following points in any notification under Paragraph PCD 4.1.2:

- (a) The purpose of the SPV;
- (b) The nature of the relationship between the bank and the SPV (i.e. sponsor, manager, investor, controller etc.);
- (c) The external auditor's proposed consolidation/accounting treatment of the SPV;
- (d) The availability of financial and other information relevant to the SPV and access to its business premises and records; and
- (e) Whether the bank is providing any guarantees, warranties or financial/liquidity support of any kind to the SPV.

PCD-4.1.4

Where the SPV is consolidated into the accounts of a locally incorporated bank, the bank must provide separate accounting information on the SPV to the CBB on a quarterly basis. Furthermore, the annual audited financial statements of all consolidated SPVs must be submitted to the CBB within 3 months of the year end of the concerned SPV.



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| CHAPTER | PCD-4: | Special Purpose Vehicles ('SPVs') |

PCD-4.1 General Requirements (continued)

PCD-4.1.5

Where a locally incorporated bank has a controller or majority ownership relationship with an SPV, or acts as sponsor, the bank must obtain the prior approval of the CBB for any changes to the capital, ownership, management or control of the SPV. All locally incorporated banks must also notify the CBB of any significant events in relation to the SPV. If necessary, the CBB may require that formal information exchange arrangements are put in place (e.g. a memorandum of understanding) if the SPV is located in a foreign jurisdiction and its activities are not supervised locally.



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:

| <u>Investee</u> | <u>Amount</u> | <u>%age of bank’s capital</u> |
|-----------------|------------------|-------------------------------|
| 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 | <u>250,000</u> | <u>25%</u> |
| 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 | <u>150,000</u> |
| 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 ¹ |
| Commercial entity “c” | 2,000,000 | 500,000 ² |
| Entity “d” | <u>500,000</u> | <u>400,000</u> ³ |
| Total | 6,500,000 | 4,900,000 |

Determination of eligible subordinated debt as Tier 2 capital:

| | |
|---|--|
| Tier 1 | = 5,000,000 |
| Goodwill | = 100,000 ⁴ |
| Tier 1 after deduction of goodwill | = 4,900,000 |
| Eligible subordinated debt (50% of above) | = 2,450,000 (However, as this amount can only be a part of Tier 2, the eligible amount of Tier 2 also needs to be observed. See below) |

Determination of eligible Tier 1 and Tier 2 capital:

| | <u>Tier 1 capital</u> | <u>Tier 2 capital</u> |
|--|-----------------------|-------------------------------|
| Capital base | 5,000,000 | 5,000,000 |
| Goodwill | (100,000) | - |
| Reciprocal cross-holding ⁵ | (400,000) | - |
| Other deductions (Equally from Tier 1 and Tier 2) (4,900,000 – 500,000 = 4,400,000 / 2) | <u>(2,200,000)</u> | <u>(2,200,000)</u> |
| Resulting capital | 2,300,000 | 2,800,000 |
| Eligible capital | 2,300,000 | 2,300,000 ⁶ |

Accordingly, limit for subordinated debt will automatically be reduced to 2,300,000.

Calculation of CAR:

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

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

¹ This investment is 30% of the insurance “b” capital.

² This investment is 20% of the bank’s capital. As such the amount exceeding 15% i.e. 500,000 will be deducted.

³ 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”.

⁴ This represents goodwill arising at the time of acquisition of a consolidated subsidiary.

⁵ As this cross-holding exists in Tier 1 capital (see footnote 3), this amount must be deducted from the same tier.

⁶ 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 = 3,000,000¹
Risk weighted assets = 20,000,000

$$\begin{aligned}\text{CAR} &= \frac{3,000,000}{20,000,000} \\ &= 15\%\end{aligned}$$

Investee:

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

$$\begin{aligned}\text{CAR} &= \frac{1,000,000}{10,000,000} \\ &= 10\%\end{aligned}$$

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%)]

$$\begin{aligned}\text{CAR} &= \frac{3,300,000}{23,000,000} \\ &= 14.35\%\end{aligned}$$

¹ 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 = 3,000,000¹
Risk weighted assets = 20,000,000

$$\begin{aligned}\text{CAR} &= \frac{3,000,000}{20,000,000} \\ &= 15\%\end{aligned}$$

Non-resident subsidiary:

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

$$\begin{aligned}\text{CAR} &= \frac{1,000,000}{10,000,000} \\ &= 10\%\end{aligned}$$

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)

$$\begin{aligned}\text{CAR} &= \frac{4,000,000}{30,000,000} \\ &= 13.33\%\end{aligned}$$

¹ 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) = $200 - (40 \times .55) = 178$

Excess investment amount above the 15% level = $178 - (1,000 \times 0.15) = 28$

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 ($18/178 \times 28$) | 2.82 |
| Deduction of 50% of remaining amount from Tier 1 ($28 - 2.82 = 25.17/2$) | 12.59 |
| Deduction of 50% of the remaining amount from Tier 2 ($28 - 2.82 = 25.17/2$) | 12.59 |
| Total deduction from capital base | <u>28.00</u> |