



|                |                             |
|----------------|-----------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b> |
| <b>CHAPTER</b> | <b>CA-A: Introduction</b>   |

## **CA-A.1 Purpose**

### *Executive Summary*

- CA-A.1.1 The purpose of this Module is to set out the Central Bank of Bahrain (CBB)'s capital adequacy Rules and provide guidance on the risk measurements for the calculation of capital requirements by Bahraini Islamic bank licensees. 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.1.2 Principle 9 of the Principles of Business requires that Islamic 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 Islamic bank licensees to maintain financial resources in excess of the minimum requirements specified in Module CA (Capital Adequacy).
- CA-A.1.3 This Module also sets out the minimum leverage requirements which Islamic bank licensees (referred to in Section CA-B.1) must meet as a condition of their licensing.
- CA-A.1.4 The requirements specified in this Module vary according to the inherent risk profile of a licensee, and the volume and type of business undertaken. As one of the principal objectives of the CBB (as outlined in Article 3 of the CBB Law 2006) is the protection of depositors, it is essential to ensure that the capital recognised in regulatory capital measures is readily available for those depositors and to ensure that Islamic bank licensees hold sufficient capital to provide some protection against unexpected losses in the normal course of business, and otherwise allow Islamic banks to effect an orderly wind-down of their operations. The minimum capital requirements specified here may not be sufficient to absorb all unexpected losses. The CBB therefore may impose more stringent capital requirements than those stated in this Module on certain banks taking into account the riskiness of the activities conducted by the concerned bank (see Paragraph CA-A.1.5A).

### **CA-A.1.5**

The CBB requires that Islamic bank licensees maintain adequate capital, in accordance with the requirements of this Module, against their risks. In particular, all Bahraini Islamic bank licensees are required to maintain capital adequacy ratios or CARs (both on a solo and a consolidated basis where applicable) above the minimum levels set out in Chapters CA-B and CA-2. Failure to remain above these ratios will result in enforcement and other measures as outlined in Section CA-1.2 and Module EN. The detailed methodology for calculating the CARs is set out in the instructions for the form PIRI.



|                |                             |
|----------------|-----------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b> |
| <b>CHAPTER</b> | <b>CA-A: Introduction</b>   |

## **CA-A.1 Purpose (continued)**

### **CA-A.1.5A**

All Bahraini Islamic bank licensees must maintain their own target capital ratios above the supervisory CARs mentioned in Section CA-B.2. Each concerned licensee must observe individual target ratios as agreed with the CBB on a case-by-case basis subject to a methodology to be disclosed in due course.

### CA-A.1.6

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) Enforcement.

### *Legal Basis*

### **CA-A.1.7**

This Module contains the CBB's Directive (as amended from time to time) relating to the capital adequacy of Islamic 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 in its entirety to all Bahraini Islamic bank licensees.

### CA-A.1.8

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



|                |                             |
|----------------|-----------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b> |
| <b>CHAPTER</b> | <b>CA-A: Introduction</b>   |

## CA-A.2 Module History

CA-A.2.1 This Module was first issued in January 2005 as part of the Islamic principles volume. Material changes took place in January 2008 to implement Basel II and the IFSB Capital Adequacy Standard (IFSB-2). Other 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.2.1A The most recent changes are detailed in the Table below.

### *Summary of Changes*

| Module Ref.                                      | Change Date | Description of Changes                                                                                                                                                                                            |
|--------------------------------------------------|-------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| CA-A.2                                           | 10/2007     | New Rule CA-A.2.5 introduced, categorising this Module as a Directive.                                                                                                                                            |
| CA-1 to CA-6                                     | 01/2008     | Basel II implementation.                                                                                                                                                                                          |
| CA-1.5                                           | 01/2008     | Review of PIR by external auditors                                                                                                                                                                                |
| CA-4.6                                           | 04/2008     | Recognition of IIRA as ECAI and mapping of ratings                                                                                                                                                                |
| CA-4.2.15-18                                     | 01/2009     | New guidance and rules on SMEs                                                                                                                                                                                    |
| CA-A                                             | 01/2011     | Various minor amendments to ensure consistency in CBB Rulebook.                                                                                                                                                   |
| CA-A.2.5                                         | 01/2011     | Clarified legal basis.                                                                                                                                                                                            |
| CA-5.1 & CA-5.3                                  | 01/2012     | Changes in respect of July 2009 and February 2011 amendments to Basel II.                                                                                                                                         |
| CA-4.2.10 and CA-4.2.11A                         | 04/2012     | Amendment made for claims on banks dealing with self-liquidating letters of credit.                                                                                                                               |
| CA-2.1.4(g)                                      | 10/2013     | Added Rule to include limited general provision against unidentified future losses as part of Tier 2.                                                                                                             |
| CA-2.1.4(f), CA-2.1.4A to CA-2.1.4C and CA-2.2.1 | 10/2013     | Added Rules to deal with subordinated issued for Tier 2 capital.                                                                                                                                                  |
| CA-5.5.13                                        | 10/2013     | Clarified Rules on structural positions for foreign exchange risk.                                                                                                                                                |
| Module CA                                        | 1/2015      | Extensive changes in respect of IFSB-15 (capital adequacy).                                                                                                                                                       |
| CA-1.3.3                                         | 04/2015     | Existing exemptions in respect of PIRI review will cease as at 31 <sup>st</sup> December 2014 for all Bahraini Islamic bank licensees.                                                                            |
| CA-2.1.2                                         | 04/2015     | Underlined the term 'financial instrument' so that it is linked to the glossary definition.                                                                                                                       |
| CA-2.4.2                                         | 04/2015     | Clarified that intangible assets other than goodwill and mortgage servicing rights are subject to transitional arrangements and are phased out as regulatory adjustments as outlined in Subparagraph CA-B.2.1(d). |
| CA-2.4.12                                        | 04/2015     | Clarified that shares of the bank held as collateral are considered as shares held indirectly and are subject to deduction under regulatory adjustments.                                                          |
| CA-2.4.25                                        | 04/2015     | Clarified the rule on significant investments in commercial entities by adding cross reference to definition.                                                                                                     |
| CA-2A.3.3                                        | 04/2015     | Paragraph deleted as not applicable on the implementation of the capital conservation buffer.                                                                                                                     |
| CA-B.2.1(d)                                      | 07/2015     | Amendment made to clarify that during the transition period, the remainder not deducted from capital is subject to the risk weights outlined in the October 2014 version of Chapter CA-3.                         |
| CA-2.4.25 and CA-2.4.26                          | 07/2015     | Amendment made to reflect the treatment of the risk weighting for exposures below the threshold limits.                                                                                                           |
| CA-6.2.5                                         | 07/2015     | Corrected the treatment of the depreciation of Ijarah assets in the definition of gross income.                                                                                                                   |
| CA-4.2.4, CA-4.2.4A and CA-4.2.4B                | 04/2016     | Updated risk weightings for claims on non-central government public sector entities (PSEs).                                                                                                                       |
| CA-9.1.4                                         | 04/2016     | Corrected cross reference.                                                                                                                                                                                        |
| CA-2.4.25                                        | 10/2016     | Updated reference to CM Module.                                                                                                                                                                                   |

|         |                      |
|---------|----------------------|
| MODULE  | CA: Capital Adequacy |
| CHAPTER | CA-A: Introduction   |

## CA-A.2 Module History (continued)

### *Evolution of Module*

|          |                                                                                                                                |
|----------|--------------------------------------------------------------------------------------------------------------------------------|
| CA-A.2.2 | The contents retained from the previous Module (Capital Adequacy – Islamic Banks) are effective from the dates depicted above. |
|----------|--------------------------------------------------------------------------------------------------------------------------------|



|                |                             |
|----------------|-----------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b> |
| <b>CHAPTER</b> | <b>CA-A: Introduction</b>   |

[Sections CA-A.3 to CA-A.4 were deleted in January 2015.]



|         |                                                   |
|---------|---------------------------------------------------|
| MODULE  | CA: Capital Adequacy                              |
| CHAPTER | CA-B: Scope of Application and Transitional Rules |

## CA-B.1 Scope

### CA-B.1.1

All Bahraini Islamic bank licensees are required to measure and apply capital charges with respect to their credit risk, operational risk and market risks capital requirements.

### CA-B.1.2

Rules in this Module are applicable to Bahraini Islamic bank licensees on both a solo (i.e. including their foreign branches) and on a consolidated group basis as described below. The applicable ratios and methodology are described in this Chapter and Chapters CA-1 and CA-2 for solo and consolidated CAR calculation.

### CA-B.1.2A

The scope of this Module includes the parent bank and all its banking subsidiaries and any other financial entities such as Special Purpose Vehicles (SPVs) which are required to be consolidated for regulatory purposes by the CBB. The assets and liabilities of all such subsidiaries must be fully consolidated on a line-by-line basis. In some cases, the assets of foreign banking subsidiaries will be allowed to be included by way of aggregation (see CA-B.1.4 onward). All other financial activities (both regulated and unregulated) must be captured through consolidation. Generally, majority-owned or controlled banking and other financial entities must be fully consolidated according to the methodologies outlined in this Module. If any majority-owned financial entities are not consolidated for capital purposes, all equity and other regulatory capital investments in those entities must be deducted and the assets and liabilities as well as third-party capital investments in the entity must be removed from the Islamic bank licensee's balance sheet.

### CA-B.1.2B

In addition, this Module applies to Islamic bank licensees on a solo basis (also including their foreign branches). This means that the assets and liabilities of subsidiaries referred to in Paragraph CA-B.1.2A must not be included in the balance sheet of the parent bank for the solo capital calculation and all equity and other regulatory capital investments in those entities must be deducted from the applicable components of Total Capital of the parent bank.

### CA-B.1.2C

Where an Islamic bank licensee has no subsidiaries as referred to in Paragraph CA-B.1.2A, then the consolidated CAR requirements of this Module apply to the Islamic bank licensee on a stand-alone basis.

### CA-B.1.2D

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



|         |                                                   |
|---------|---------------------------------------------------|
| MODULE  | CA: Capital Adequacy                              |
| CHAPTER | CA-B: Scope of Application and Transitional Rules |

## CA-B.1 Scope

**CA-B.1.3** If Islamic bank licensees have investments in or control over banking or financial entities, including SPVs, they will also need to apply rules set out in Section CA-2.4 of this Module for the calculation of their solo and consolidated Capital Adequacy Ratios (CAR).

### *Full Consolidation versus Aggregation*

CA-B.1.4 Generally, wherever possible, the assets and liabilities of banking subsidiaries must be consolidated on a line-by-line basis using the risk-weighting and other rules and guidance in this Module. In some cases, foreign banking subsidiaries are subject to slightly differing rules by their host regulator. In such cases it may be more convenient to add in the risk-weighted assets of the subsidiary as calculated by host rules rather than by adding in the assets of the subsidiary and subjecting them to CBB requirements and risk weights. This process of using host risk-weights instead of CBB risk-weights is termed ‘aggregation’. Also host rules may treat some capital items differently to CBB rules. For example, T2 instruments may have different rules in host countries. There may therefore need to be a ‘haircut’ to such capital instruments, if the amount allowed by the host regulator is different to the amount of the investment by the parent bank.

**CA-B.1.5** For the reasons outlined in CA-B.1.2A to CA-B.1.4, banks must agree the proposed regulatory consolidation and aggregation approaches for banking and financial entity subsidiaries with the CBB and their external auditor.

**CA-B.1.6** If a banking or financial entity subsidiary is to be consolidated by way of aggregation, 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.

**CA-B.1.7** Appropriate adjustments must be made to eliminate intra-group exposures.

**CA-B.1.8** If a bank in Bahrain is a subsidiary of a non-resident parent bank, the capital adequacy of such bank must be determined on a standalone basis.

**CA-B.1.9** Majority-owned or controlled financial entity subsidiaries must be adequately capitalised to reduce the possibility of future potential losses to the parent bank. The parent bank must monitor actions taken by the subsidiary to correct any capital shortfall and, if it is not corrected in a timely manner, the shortfall must also be deducted from the parent bank’s solo and consolidated capital for regulatory capital purposes.



|         |                                                   |
|---------|---------------------------------------------------|
| MODULE  | CA: Capital Adequacy                              |
| CHAPTER | CA-B: Scope of Application and Transitional Rules |

## CA-B.2 Transitional Arrangements

### CA-B.2.1

The transitional arrangements for implementing the new standards help to ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. The transitional arrangements are as follows:

- (a) Implementation of this Module begins on 1 January 2015. As of 1 January 2015, Islamic bank licensees are required to meet each of the following new minimum CAR requirements taking each component of capital as defined in Chapters CA-2 and CA-2A divided by total risk-weighted assets (RWAs) as defined in Paragraph CA-1.1.3:

| Components of Consolidated CARs               |          |                        |
|-----------------------------------------------|----------|------------------------|
|                                               | Optional | Minimum Ratio Required |
| Core Equity Tier 1 (CET1)                     |          | 6.5%                   |
| Additional Tier 1 (AT1)                       | 1.5%     |                        |
| Tier 1 (T1)                                   |          | 8%                     |
| Tier 2 (T2)                                   | 2%       |                        |
| Total Capital                                 |          | 10%                    |
| Capital Conservation Buffer (CCB) (see below) |          | 2.5%                   |
| CARs including CCB                            |          |                        |
| CET 1 plus CCB                                |          | 9%                     |
| Tier 1 plus CCB                               |          | 10.5%                  |
| Total Capital plus CCB                        |          | 12.5%                  |

| Components of Solo CARs                       |          |                        |
|-----------------------------------------------|----------|------------------------|
|                                               | Optional | Minimum Ratio Required |
| Core Equity Tier 1 (CET1)                     |          | 4.5%                   |
| Additional Tier 1 (AT1)                       | 1.5%     |                        |
| Tier 1 (T1)                                   |          | 6.0%                   |
| Tier 2 (T2)                                   | 2%       |                        |
| Total Capital                                 |          | 8.0%                   |
| Capital Conservation Buffer (CCB) (see below) |          | 0%                     |
| CARs including CCB                            |          |                        |
| CET 1 plus CCB                                |          | N/A                    |
| Tier 1 plus CCB                               |          | N/A                    |
| Total Capital plus CCB                        |          | N/A                    |

- (b) The difference between the Total Capital plus the CCB (Capital Conservation Buffer – for further explanation see Chapter CA-2A.) of 12.5% and the T1 plus CCB requirement of 10.5% for the consolidated CAR can be met with T2 and higher forms of capital;



|         |                                                   |
|---------|---------------------------------------------------|
| MODULE  | CA: Capital Adequacy                              |
| CHAPTER | CA-B: Scope of Application and Transitional Rules |

## CA-B.2 Transitional Arrangements (continued)

- (c) The regulatory adjustments (i.e. deductions), including amounts above the aggregate 15% limit for significant investments in financial institutions, mortgage servicing rights, and deferred tax assets from temporary differences, are fully deducted from CET1 by 1 January 2019;
- (d) The regulatory adjustments (refer to Section CA-2.4) begin at 20% of the required adjustments to CET 1 on 1 January 2015, 40% on 1 January 2016, 60% on 1 January 2017, 80% on 1 January 2018, and reach 100% on 1 January 2019. The same transition approach applies to deductions from AT1 and T2 capital. Specifically, the regulatory adjustments to AT1 and T2 capital begin at 20% of the required deductions on 1 January 2015, 40% on 1 January 2016, 60% on 1 January 2017, 80% on 1 January 2018, and reach 100% on 1 January 2019. During this transition period, the remainder of exposures held prior to 1<sup>st</sup> January 2015 not deducted from capital is subject to the risk weights outlined in the October 2014 version of Chapter CA-3;
- (e) The treatment of capital issued out of subsidiaries and held by third parties (e.g. minority interest) is also phased in. Where such capital is eligible for inclusion in one of the three components of capital according to Paragraphs CA-2.3.1 to CA-2.3.5, it can be included from 1 January 2015. Where such capital is not eligible for inclusion in one of the three components of capital but is included under the existing treatment, 20% of this amount must be excluded from the relevant component of capital on 1 January 2015, 40% on 1 January 2016, 60% on 1 January 2017, 80% on 1 January 2018, and reach 100% on 1 January 2019;
- (f) Capital instruments that no longer qualify as non-common equity T1 capital or T2 capital are phased out beginning 1 January 2015. Fixing the base at the nominal amount of such instruments outstanding on 1 January 2015, their recognition is capped at 90% from 1 January 2015, with the cap reducing by 10 percentage points in each subsequent year. This cap is applied to AT1 and T2 separately and refers to the total amount of instruments outstanding that no longer meet the relevant entry criteria. To the extent an instrument is redeemed, or its recognition in capital is amortised, after 1 January 2015, the nominal amount serving as the base is not reduced. In addition, instruments with an incentive to be redeemed are treated as follows:



|                |                                                          |
|----------------|----------------------------------------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b>                              |
| <b>CHAPTER</b> | <b>CA-B: Scope of Application and Transitional Rules</b> |

## **CA-B.2 Transitional Arrangements (continued)**

- (i) For an instrument that has a call prior to 1 January 2015 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward-looking basis will meet the new criteria for inclusion in T1 or T2, it continues to be recognised in that tier of capital;
- (ii) For an instrument that has a call on or after 1 January 2015 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis meets the new criteria for inclusion in T1 or T2, it continues to be recognised in that tier of capital. Prior to the effective maturity date, the instrument would be considered an “instrument that no longer qualifies as AT1 or T2” and is therefore phased out from 1 January 2015;
- (iii) For an instrument that has a call between 12 September 2012 and 1 January 2015 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis does not meet the new criteria for inclusion in T1 or T2, it is fully derecognised in that tier of regulatory capital from 1 January 2015;
- (iv) For an instrument that has a call on or after 1 January 2015 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis does not meet the new criteria for inclusion in T1 or T2, it is derecognised in that tier of regulatory capital from the effective maturity date. Prior to the effective maturity date, the instrument would be considered an “instrument that no longer qualifies as AT1 or T2” and is therefore phased out from 1 January 2015; and
- (v) For an instrument that had a call on or prior to 12 September 2012 (or another incentive to be redeemed), if the instrument was not called at its effective maturity date and on a forward looking basis does not meet the new criteria for inclusion in T1 or T2, it is considered an “instrument that no longer qualifies as AT1 or T2” and is therefore phased out from 1 January 2015.

### **CA-B.2.2**

Capital instruments that do not meet the criteria for inclusion in CET1 are excluded from CET1 as of 1 January 2015.

### **CA-B.2.3**

Only those instruments issued before 12 September 2012 qualify for the transition arrangements outlined in Paragraph CA-B.2.1.



|         |                            |
|---------|----------------------------|
| MODULE  | CA: Capital Adequacy       |
| CHAPTER | CA-1: General Requirements |

## CA-1.1 Capital Adequacy Ratio (Definition and Methodology)

**CA-1.1.1** An Islamic bank licensee's consolidated capital adequacy ratio is calculated by dividing its consolidated Total Capital by its consolidated risk-weighted assets (RWAs). These items are defined and described in Paragraphs CA-1.1.2 and CA-1.1.3. A full explanation of the formula used to calculate the consolidated CAR is given below.

### *Consolidated Total Capital*

**CA-1.1.2** Consolidated Total Capital consists of the sum of the following elements:

- (a) T1 (Going-concern):
  - (i) CET1 (as defined in Paragraph CA-2.1.2);
  - (ii) AT1 (as defined in Paragraph CA-2.1.4); and
- (b) T2 (Gone-concern) as defined in Paragraph CA-2.1.8.

### *Consolidated Risk-weighted Assets*

**CA-1.1.3** Consolidated Total risk-weighted assets are determined by:

- (a) Multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 12.5 for the Islamic bank licensee and all its consolidated subsidiaries; and
- (b) Adding the resulting figures to the sum of risk-weighted assets for credit risk (see CA-1.1.4) and securitisation risk for the Islamic bank licensee and all its subsidiaries (see CA-1.1.5).

**CA-1.1.4** For the measurement of their credit risks, Islamic bank licensees measure the risks in the standardised approach, applying the measurement framework described in Chapters CA-3, CA-4, and CA-9 (real estate) and subject to the credit mitigation techniques outlined in Section CA-4.7 of this Module and subject to any adjustments described in Paragraphs CA-1.1.9 onward in relation to assets funded by Profit Sharing Investment Accounts (PSIAs).

**CA-1.1.5** The Sukuk and securitisation framework is set out in Chapter CA-8. Islamic bank licensees must apply this framework for determining regulatory capital requirements on exposures arising from traditional securitisations or sukuku.



|         |                            |
|---------|----------------------------|
| MODULE  | CA: Capital Adequacy       |
| CHAPTER | CA-1: General Requirements |

## CA-1.1 Capital Adequacy Ratio (continued)

### CA-1.1.6

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

- (a) The basic indicator approach, by applying the measurement framework described in Chapter CA-6 of this Module; and
- (b) The standardised approach (also in Chapter CA-6). This approach is subject to certain conditions (outlined in Chapter OM-8) and requires the explicit approval of the CBB.

### CA-1.1.7

For the measurement of market risk in the trading book, Islamic bank licensees must measure the risks in a standardised approach, applying the measurement frameworks described in Chapter CA-5 of this Module. Market risk inherent in certain Shari'a compliant products is outlined in detail in Chapter CA-3. The treatment of market risk positions funded by PSIA is given in Paragraphs CA-1.1.9 onward.

### CA-1.1.8

In light of Paragraphs CA-1.1.3 to CA-1.1.7, each Islamic bank licensee's overall capital requirement consists of:

- (a) The credit risk requirements laid down in Chapters CA-3, CA-4, and CA-9 (subject to any PSIA adjustment below) and the charges in respect of sukuk and securitisations in Chapter CA-8 and including the credit counterparty risk on all over-the-counter Shari'a compliant hedging contracts whether in the trading or the banking books (see CA-4.5.15-16 and Appendix CA-2);
- (b) The capital charges for operational risk described in Chapter CA-6; and
- (c) The capital charges for market risks described in Chapters CA-3 and CA-5 summed arithmetically subject to any PSIA adjustment below.

### *Adjustment to the Capital Ratio Denominator*

#### CA-1.1.9

The capital amount of PSIA is not guaranteed by the Islamic bank licensee due to the profit-sharing nature of the underlying Mudarabah contract. Therefore, any losses arising from investments or assets financed by PSIA are to be borne by the Investment Account Holders. Nevertheless, IAH are not liable for any losses arising from the Islamic bank licensee's negligence, misconduct, fraud or breach of its investment mandate, which is characterised as a fiduciary risk and considered part of the Islamic bank licensee's operational risk.



|         |                            |
|---------|----------------------------|
| MODULE  | CA: Capital Adequacy       |
| CHAPTER | CA-1: General Requirements |

## CA-1.1 Capital Adequacy Ratio (continued)

CA-1.1.10 An Islamic bank licensee may be constructively obliged to smooth the profits payout to Unrestricted PSIA's (UPSIA's). A necessary consequence of some of these smoothing practices adopted by Islamic bank licensees is that a portion of risk (i.e. volatility of the stream of profits) arising from assets financed by UPSIA's is effectively transferred to the Islamic bank licensee's own capital, a phenomenon known as "displaced commercial risk" (DCR).

### CA-1.1.11

The CBB requires regulatory capital to be held to cater for DCR and the operational risk mentioned in Paragraph CA-6.1.1 in view of the residual risk to the Islamic bank licensee and its shareholders. To be prudent, the CBB requires Islamic bank licensees to provide regulatory capital to cover a minimum requirement arising from 30% of the risk weighted assets and contingencies financed by the UPSIA's. Therefore, for the purpose of calculating its Capital Adequacy Ratio (CAR), the risk-weighted assets of an Islamic bank licensee consist of the sum of the risk-weighted assets financed by the Islamic bank licensee's own capital and liabilities, plus 30% (shown below as  $\alpha$ ) of the risk-weighted assets financed by the Islamic bank licensee's UPSIA's as outlined in Paragraph CA-1.1.12.

### CA-1.1.12

For the purpose of this Module the consolidated CAR is calculated by applying the Total Capital (as defined in Paragraph CA-1.1.2) to the numerator and risk-weighted assets (RWAs) as defined in Paragraph CA-1.1.3) to the denominator as shown below.

$$\frac{\text{Total Capital}}{\{\text{Self-financed RWAs (Credit + Market Risks) + Operational Risks}$$

Plus

$$\alpha [\text{RWAs funded by UPSIA's}^a (\text{Credit + Market Risks}) - \text{PER and IRR of UPSIA's}]$$

- (a) Where the funds are commingled, the RWA funded by UPSIA are calculated based on their pro-rata share of the relevant assets.
- (b)  $\alpha$  refers to the proportion assets funded by UPSIA which, as determined by the CBB, is 30%; and
- (c) The UPSIA's' share of PER and the IRR is deducted from the total RWAs funded by the UPSIA's. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

This formula is applicable as the Islamic bank licensees may smooth income to the UPSIA's as a mechanism to minimise withdrawal risk.



|         |                            |
|---------|----------------------------|
| MODULE  | CA: Capital Adequacy       |
| CHAPTER | CA-1: General Requirements |

## CA-1.1 Capital Adequacy Ratio (continued)

### CA-1.1.13

All transactions, including forward sales and purchases, must be included in the calculation of capital requirements as from the date on which they were entered into. Although regular reporting takes place quarterly, Islamic bank licensees must manage their risks in such a way that the capital and leverage requirements are being met on a continuous basis, i.e. at the close of each business day. Islamic bank licensees must not “window-dress” by showing significantly lower credit or market risk positions on reporting dates. Islamic bank licensees must maintain strict risk management systems to ensure that intra-day exposures are not excessive. If an Islamic bank licensee fails to meet the capital requirements of this Module, the Islamic bank licensee must take immediate measures to rectify the situation as detailed in Section CA-1.2.

### *Solo Capital Adequacy Ratio*

### CA-1.1.14

An Islamic bank licensee's solo capital adequacy ratio is calculated by dividing its Solo Total Capital by its Solo risk-weighted assets as described in Paragraph CA-1.1.15 and CA-1.1.16 without consolidating the assets and liabilities of subsidiaries referred to Paragraph CA-B.1.2A into the balance sheet of the parent bank.

### *Solo Total Capital*

### CA-1.1.15

Solo Total Capital consists of the sum of the following elements:

- (a) T1 (Going-concern):
  - (i) CET1 for the parent bank only (as defined in Paragraph CA-2.1.2 but deducting item (c) before applying regulatory adjustments in item (d);
  - (ii) AT1 for the parent bank only (as defined in Paragraph CA-2.1.4 but deducting item (c) before applying regulatory adjustments in item (d); and
- (b) T2 (Gone-concern) for the parent bank only as defined in Paragraph CA-2.1.8 but deducting item (c) before applying regulatory adjustments in item (d).

### *Solo Risk-weighted Assets*

### CA-1.1.16

Solo Total risk-weighted assets are determined by:

- (a) Multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 12.5 for the parent bank alone; and



|         |       |                      |
|---------|-------|----------------------|
| MODULE  | CA:   | Capital Adequacy     |
| CHAPTER | CA-1: | General Requirements |

## CA-1.1 Capital Adequacy Ratio (continued)

- (b) Adding the resulting figures to the sum of risk-weighted assets for credit risk (see CA-1.1.4) and securitisation risk for the parent bank alone (see CA-1.1.5).

### CA-1.1.17

For the purpose of this Module the solo CAR is calculated by applying the Solo Total Capital (as defined in Paragraph CA-1.1.15) to the numerator and solo risk-weighted assets (RWAs) as defined in Paragraph CA-1.1.16) to the denominator as shown below.

#### Total Capital

{Self-financed RWAs (Credit + Market Risks) + Operational Risks

Plus

$\alpha$  [RWAs funded by UPSIAs<sup>a</sup> (Credit + Market Risks) -  
PER and IRR of UPSIAs]}

- (a) Where the funds are commingled, the RWA funded by UPSIA are calculated based on their pro-rata share of the relevant assets.
- (b)  $\alpha$  refers to the proportion assets funded by UPSIA which, as determined by the CBB, is 30%; and
- (c) The UPSIAs' share of PER and the IRR is deducted from the total RWAs funded by the UPSIAs. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

This formula is applicable as the Islamic bank licensees may smooth income to the UPSIAs as a mechanism to minimise withdrawal risk.



|                |                                   |
|----------------|-----------------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b>       |
| <b>CHAPTER</b> | <b>CA-1: General Requirements</b> |

## **CA-1.2 Reporting**

**CA-1.2.1** Formal reporting to the CBB of capital adequacy must be made in accordance with the requirements set out under Section BR-3.1.

**CA-1.2.2** All Bahraini Islamic bank licensees 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 ratios outlined in Subparagraph CA-B.2.1(a). Where such notification is given, the Islamic bank licensee must also provide the CBB:

- (a) No later than one calendar week after the notification, with a written action plan setting out how the Islamic bank licensee proposes to restore the relevant ratios to the required minimum level(s), further, describing how the Islamic bank licensee will ensure that a breach of such ratios will not occur again in the future;
- (b) Weekly reports thereafter on the Islamic bank licensee's relevant ratios until such ratios have reached the required minimum level(s) described in Subparagraph CA-B.2.1(a); and
- (c) The Islamic bank licensee must take additional note of the Capital Conservation Plan requirements in Chapter CA-2A where additional action is required when the Capital Conservation buffer has been breached.

**CA-1.2.3** The Islamic bank licensee is required to submit form PIRI to the CBB on a weekly basis, until the concerned CARs identified in Paragraph CA-1.2.2 exceed the required minimum ratios.

CA-1.2.4 The CBB will notify Islamic bank licensees in writing of any action required of them with regard to the corrective and preventive action (as appropriate) proposed by the Islamic bank licensee pursuant to the above, as well as of any other requirement of the CBB in any particular case.

CA-1.2.5 Islamic bank licensees should note that the CBB considers the breach of regulatory CARs to be a very serious matter. Consequently, the CBB may (at its discretion) subject an Islamic bank licensee 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 appointed experts, as appropriate. Following such appraisal, the CBB will notify the Islamic bank licensee concerned in writing of its conclusions with regard to the continued licensing of the Islamic bank licensee.

CA-1.2.6 The CBB recommends that the Islamic bank licensee'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 the concerned Islamic bank licensees and their subsidiaries and other group companies have adequate internal systems and controls to comply with these rules.



|         |       |                      |
|---------|-------|----------------------|
| MODULE  | CA:   | Capital Adequacy     |
| CHAPTER | CA-1: | General Requirements |

### CA-1.3 Review of Prudential Information Returns

**CA-1.3.1** The CBB requires all Islamic bank licensees to request their external auditor to conduct a review of the prudential returns on a quarterly basis in accordance with the requirements set out under Section BR 3.1.

CA-1.3.2 If an Islamic bank licensee 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.

CA-1.3.3 For Bahraini Islamic bank licensees all existing exemptions in respect of PIRI review as at 31<sup>st</sup> December 2014 will cease.

**CA-1.3.4** Islamic bank licensees' daily compliance with the capital requirements for credit and market risk must be verified by the independent risk management department and the internal auditor.



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

## CA-2.1 Regulatory Capital

### *Tier 1 (T1)*

#### CA-2.1.1

The predominant form of T1 capital must be common shares and retained earnings (hereafter referred to as CET1). Deductions from capital and prudential filters are applied at the level of CET1 (see CA-2.1 to CA-2.4 for a more detailed explanation). The remainder of the T1 capital must be comprised of instruments that are subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.

### *Common Equity Tier 1 (CET1)*

#### CA-2.1.2

CET1 capital consists of the sum of:

- (a) Issued and fully paid common shares that meet the criteria for classification as common shares for regulatory purposes (see CA-2.1.3);
- (b) Disclosed reserves including:
  - (i) General reserves;
  - (ii) Legal / statutory reserves;
  - (iii) Share premium;
  - (iv) Fair value reserves arising from fair valuing financial instruments; and
  - (v) Retained earnings or losses (including net profit and loss for the reporting period, whether reviewed or audited);
- (c) Common shares issued by consolidated banking subsidiaries of the Islamic bank licensee and held by third parties (i.e. minority interest) that meet the criteria for inclusion in CET1. See Section CA-2.3 for the relevant criteria; and
- (d) Regulatory adjustments (including unrealised losses) applied in the calculation of CET1 (see Section CA-2.4).

#### CA-2.1.2A

For unrealised fair value reserves relating to financial instruments to be included in CET1 Capital, Islamic bank licensees and their auditor must only recognise such gains or losses that are prudently valued and independently verifiable (e.g. by reference to market prices). The CBB will closely review the components and extent of unrealised gains and losses and will exclude any that do not have reference to independent valuations (i.e. those made by bank management alone will not be included) or which are not deemed to be made on a prudent basis. As such, the prudent valuations, and the independent verification thereof, are mandatory. Unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk must be derecognised in the calculation of CET1



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

## CA-2.1 Regulatory Capital (continued)

### CA-2.1.3

For a common share to be included in CET1, it must meet the following criteria:

- (a) It is directly issued to shareholders and fully paid in;
- (b) It is non-cumulative;
- (c) It is able to absorb losses within the Islamic bank licensee on a going-concern basis;
- (d) It is neither secured nor covered by a guarantee of the issuer or a related entity or any other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors;
- (e) It represents the most subordinated claim in liquidation of the Islamic bank licensee (i.e. it is junior to depositors, general creditors, and subordinated capital instruments of the bank);
- (f) It is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. it has an unlimited and variable claim, not a fixed or capped claim);
- (g) Its principal is perpetual and never repaid outside of liquidation;
- (h) The Islamic bank licensee does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation;
- (i) Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items);
- (j) There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default;
- (k) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions;
- (l) It is the issued capital that takes the first and proportionately greatest share of any losses as they occur;
- (m) The paid in amount is recognised as equity capital (i.e. it is not recognised as a liability) for determining balance sheet insolvency;
- (n) The paid in amount is classified as equity under AAOIFI standards and disclosed separately in the financial statements;



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

## CA-2.1 Regulatory Capital (continued)

- (o) The Islamic bank licensee cannot directly or indirectly have funded the purchase of the instrument (i.e. treasury shares and shares purchased or funded by the Islamic bank licensee for employee share purchase schemes must be deducted from CET1, and are subject to the 10% limit under the Commercial Companies' Law. Any of the Islamic bank licensee's own shares used as collateral for the advance of funds to its customers must be deducted from CET1 and are also subject to the above 10% limit); and
- (p) It is only issued with the approval of the shareholders of the issuing Islamic bank licensee;

### *Additional Tier 1 (AT1) Capital*

#### CA-2.1.4

AT1 capital consists of the sum of:

- (a) Instruments issued by the Islamic bank licensee that meet the criteria for inclusion in AT1 outlined in Paragraph CA-2.1.6;
- (b) Stock surplus (share premium) resulting from the issue of instruments included in AT1;
- (c) Instruments issued by consolidated banking subsidiaries of the Islamic bank licensee and held by third parties that meet the criteria for inclusion in AT1 and are not included in CET1. See Section CA-2.3 for the relevant criteria; and
- (d) Regulatory adjustments applied in the calculation of AT1 (see Section CA-2.4).

#### CA-2.1.5

[This Paragraph has been left blank.]

#### CA-2.1.6

For an instrument to be included in AT1, it must meet or exceed all the criteria below:

- (a) It is issued and paid-in;
- (b) It is subordinated to depositors and general creditors of the Islamic bank licensee;
- (c) It is neither 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 Islamic bank licensee creditors;
- (d) It is perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem;



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

### CA-2.1 Regulatory Capital (continued)

- (e) It may be callable at the initiative of the issuer only after a minimum of five years and an Islamic bank licensee must not do anything which creates an expectation that the call will be exercised. An Islamic bank licensee may not exercise such a call option without receiving prior written approval of the CBB and the called instrument is replaced with capital of the same or better quality; or the Islamic bank licensee demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised
- (f) In all early call situations, replacement of existing capital must be done at conditions which are sustainable for the income capacity of the Islamic bank licensee;
- (g) Any repayment of principal (e.g. through repurchase or redemption) must be with prior written approval of the CBB and Islamic bank licensees must not assume or create market expectations that supervisory approval will be given;
- (h) The Islamic bank licensee must have full discretion at all times to cancel distributions/payments. This means that ‘dividend pushers’ are prohibited. A dividend pusher obliges a bank to make a dividend or coupon payment on an instrument if it has made a payment on another capital instrument or share. Also features that require the Islamic bank licensee to make distributions in kind are not permitted;
- (i) Cancellation of discretionary payments must not be an event of default;
- (j) Islamic bank licensees must have full access to cancelled payments to meet obligations as they fall due;
- (k) Cancellation of distributions/payments must not impose restrictions on the Islamic bank licensees except in relation to distributions to common stockholders;
- (l) Dividends/coupons must be paid out of distributable items;
- (m) The instrument cannot have a credit sensitive dividend feature (this might serve to increase the dividend payable if a bank’s credit rating falls from A to BBB, for example) which may lead to the dividend/coupon being reset periodically based in whole or in part on the Islamic bank licensee’s credit standing;
- (n) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law. This means that instruments accounted for as liabilities must be able to be written down in some way as described in subparagraph (o);



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

## CA-2.1 Regulatory Capital (continued)

- (o) Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger event; or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger event. The write-down will reduce the claim of the instrument in liquidation and reduce the amount that will be re-paid when a call is exercised and partially or fully reduce coupon/dividend payments on the instrument;
- (p) Neither the Islamic bank licensee nor a related party over which it exercises control or significant influence can have purchased the instrument, nor can the Islamic bank licensee directly or indirectly have funded the purchase of the instrument. This also means that own holdings of AT1 instruments and AT1 instruments purchased or funded by the bank for employee share purchase schemes must be deducted from AT1. Any of the Islamic bank licensee's AT1 instruments used as collateral for the advance of funds to its customers must be deducted from AT1;
- (q) The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame; and
- (r) If the instrument is not issued out of a fully consolidated subsidiary bank or the parent Islamic bank licensee in the consolidated group (e.g. a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to the parent bank in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in AT1.

CA-2.1.7 [This paragraph has been left blank.]

### CA-2.1.7A

The issuance of any new shares as a result of a trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.



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

## CA-2.1 Regulatory Capital (continued)

**CA-2.1.7B** Where an issuing bank or SPV is part of a banking group and the issuer wishes the instrument to be included in the total capital of the group (in addition to its solo capital where applicable), the terms and conditions must specify an additional trigger event.

**CA-2.1.7C** Any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or the parent bank of the group (including any successor in resolution).

### *Write Down or Conversion of Additional Tier 1 Instruments*

**CA-2.1.7D** For the purposes of Subparagraph CA-2.1.6(o), the following provisions apply to AT1 instruments accounted for as liabilities:

- (a) A trigger event occurs when the CET1 capital ratio of the Islamic bank licensee referred to in Subparagraph CA-B.2.1(a) falls below either of the following:
  - (i) 7.0%; or
  - (ii) A level higher than 7.0 %, where determined by the Islamic bank licensee and specified in the provisions governing the instrument; and
- (b) Islamic bank licensees may specify in the provisions governing the instrument one or more trigger events in addition to that referred to in Subparagraph (a).

**CA-2.1.7E** Where the provisions governing AT1 instruments require them to be converted into CET1 instruments upon the occurrence of a trigger event, those provisions must specify either of the following:

- (a) The rate of such conversion and a limit on the permitted amount of conversion; or
- (b) A range within which the instruments will convert into CET1 instruments.



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

## CA-2.1 Regulatory Capital (continued)

- CA-2.1.7F** Where the provisions governing AT1 instruments require their principal amount to be written down upon the occurrence of a trigger event, the write down must reduce all the following:
- (a) The claim of the holder of the instrument in the insolvency or liquidation of the Islamic bank licensee;
  - (b) The amount required to be paid in the event of the call or redemption of the instrument; and
  - (c) The distributions made on the instrument.
- CA-2.1.7G** Write down or conversion of an AT1 instrument must, under the applicable accounting framework, generate items that qualify as CET1 items.
- CA-2.1.7H** The amount of AT1 instruments recognised in AT1 items is limited to the minimum amount of CET1 items that would be generated if the principal amount of the AT1 instruments were fully written down or converted into CET1 instruments.
- CA-2.1.7I** The aggregate amount of AT1 instruments that is required to be written down or converted upon the occurrence of a trigger event must be no less than the lower of the following:
- (a) The amount required to restore fully the CET1 ratio of the Islamic bank licensee to 7.0 %; and
  - (b) The full principal amount of the instrument.
- CA-2.1.7J** When a trigger event occurs Islamic bank licensees must do the following:
- (a) Immediately inform the CBB;
  - (b) Inform the holders of the AT1 instruments; and
  - (c) Write down the principal amount of the instruments, or convert the instruments into CET1 instruments without delay, but no later than within one month, in accordance with the requirement laid down in this Section.
- CA-2.1.7K** A Islamic bank licensee issuing AT1 instruments that convert to CET1 on the occurrence of a trigger event must ensure that its authorised share capital is at all times sufficient, for converting all such convertible AT1 instruments into shares if a trigger event occurs.



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

## CA-2.1 Regulatory Capital (continued)

### CA-2.1.7L

All necessary authorisations must be obtained at the date of issuance of such convertible AT1 instruments. The Islamic bank licensee must maintain at all times the necessary prior authorisation from the CBB to issue the CET1 instruments into which such AT1 instruments would convert upon occurrence of a trigger event.

### CA-2.1.7M

An Islamic bank licensee issuing AT1 instruments that convert to CET1 on the occurrence of a trigger event must ensure that there are no procedural impediments to that conversion by virtue of its incorporation or statutes or contractual arrangements.

### *Consequences of the Conditions for AT1 Instruments Ceasing to Be Met*

### CA-2.1.7N

The following must apply where, in the case of an AT1 instrument, the conditions laid down in Paragraph CA-2.1.6 cease to be met:

- That instrument must immediately cease to qualify as an AT1 instrument; and
- The part of the share premium accounts that relates to that instrument must immediately cease to qualify as an AT1 item.

### *Tier 2 Capital(T2)*

### CA-2.1.8

T2 capital consists of the sum of the following items

- Instruments issued by the Islamic bank licensee that meet the criteria for inclusion in T2 capital outlined in Paragraph CA-2.1.10;
- Stock surplus (share premium) resulting from the issue of instruments included in T2 capital;
- Instruments issued by consolidated banking subsidiaries of the Islamic bank licensee and held by third parties that meet the criteria for inclusion in T2 capital and are not included in T1. See Section CA-2.3 for the relevant criteria;
- General provisions held against future, presently unidentified losses on financing which are freely available to meet losses which subsequently materialise and qualify for inclusion within T2. Such general provisions which are eligible for inclusion in T2 are limited to a maximum of 1.25 percentage points of credit risk-weighted risk assets. Provisions ascribed to identified deterioration of particular financing assets or known liabilities, whether individual or grouped, must be excluded from T2 Capital;



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

## CA-2.1 Regulatory Capital (continued)

- (e) Regulatory adjustments applied in the calculation of T2 Capital (see CA-2.4); and
- (f) 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 T2 capital, with the concurrence of the external auditor, provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale.

CA-2.1.9 The treatment of instruments issued out of consolidated subsidiaries of the Islamic bank licensee and the regulatory adjustments applied in the calculation of T2 Capital are addressed in Section CA-2.3.

### CA-2.1.10

For an instrument to be included in T2 capital (see CA-2.1.8(a)), it must meet all the criteria below:

- (a) It is issued and paid-in;
- (b) It is subordinated to depositors and general creditors of the Islamic bank licensee;
- (c) It is neither secured nor covered by a guarantee of the issuing Islamic bank licensee or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general creditors of the Islamic bank licensee;
- (d) It must have a minimum maturity of at least 5 years and it will be amortised on a straight line basis in the remaining five years before maturity and there are no step-ups or other incentives to redeem;
- (e) It may be callable at the initiative of the Islamic bank licensee only after a minimum of five years and the Islamic bank licensee must not do anything which creates an expectation that the call will be exercised. The Islamic bank licensee may not exercise such a call option without receiving written prior approval of the CBB and the called instrument must be replaced with capital of the same or better quality; or the Islamic bank licensee demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised. In all early call situations, any replacement of existing capital must be done at conditions which are sustainable for the income capacity of the Islamic bank licensee;



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

### CA-2.1 Regulatory Capital (continued)

- (f) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation;
- (g) The instrument cannot have a credit sensitive dividend/coupon that is reset periodically based in whole or in part on the Islamic bank licensee's credit standing;
- (h) Neither the issuing bank nor a related party over which the Islamic bank licensee exercises control or significant influence can have purchased the instrument, nor can the Islamic bank licensee directly or indirectly have funded the purchase of the instrument. This means own holdings of T2 instruments and T2 purchased or funded by the Islamic bank licensee for employee share purchase schemes must be deducted from T2. Any of the Islamic bank licensee's own T2 instruments used as collateral for the advance of funds to its customers must be deducted from T2;
- (i) If the instrument is not issued out of a fully consolidated subsidiary bank or the parent Islamic bank licensee in the consolidated group (e.g. a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to the parent Islamic bank licensee in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in T2 capital; and
- (j) Subject to Shari'a compliance, an Islamic bank licensee can issue T2 capital instruments in the form of Mudarabah or Wakalah Sukuk, which would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. It is essential that the terms of conversion, notably the trigger event and the conversion ratio, are clearly specified in the Sukuk contract so as to avoid gharar. Prior to conversion, the underlying assets of such Sukuk would not be available to meet the claims of the Islamic bank licensee's current account holders or other creditors. After conversion of the Sukuk in case of the Islamic bank licensee's non-viability or insolvency, the resulting CET1 capital would rank pari passu with other CET1 shareholders.



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

## CA-2.1 Regulatory Capital (continued)

CA-2.1.10A [This paragraph has been left blank.]

**CA-2.1.10B** The issuance of any new shares as a result of a trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

**CA-2.1.10C** Where an issuing bank or SPV is part of a banking group and the issuer wishes the instrument to be included in the total capital of the group (in addition to its solo capital where applicable), the terms and conditions must specify an additional trigger event.

**CA-2.1.10D** Any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or the parent bank of the group (including any successor in resolution).

### *Write Down or Conversion of Tier 2 Instruments*

**CA-2.1.10E** For the purposes of Subparagraph CA-2.1.10(j), the following provisions apply to T2 Sukuk instruments:

- (a) A trigger event occurs when the CET1 capital ratio of the Islamic bank licensee referred to in Subparagraph CA-B.2.1(a) falls below either of the following:
  - (i) 7.0%; or
  - (ii) A level higher than 7.0 %, where determined by the Islamic bank licensee and specified in the provisions governing the instrument; and
- (b) Islamic bank licensees may specify in the provisions governing the instrument one or more trigger events in addition to that referred to in Subparagraph (a).



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

## CA-2.1 Regulatory Capital (continued)

- CA-2.1.10F** Where the provisions governing T2 instruments require them to be converted into CET1 instruments upon the occurrence of a trigger event, those provisions must specify either of the following:
- The rate of such conversion and a limit on the permitted amount of conversion; or
  - A range within which the instruments will convert into CET1 instruments.
- CA-2.1.10G** Where the provisions governing T2 instruments require their principal amount to be written down upon the occurrence of a trigger event, the write down must reduce all the following:
- The claim of the holder of the instrument in the insolvency or liquidation of the Islamic bank licensee;
  - The amount required to be paid in the event of the call or redemption of the instrument; and
  - The distributions made on the instrument.
- CA-2.1.10H** Write down or conversion of a T2 instrument must, under the applicable accounting framework, generate items that qualify as CET1 items.
- CA-2.1.10I** The amount of T2 instruments recognised in T2 items is limited to the minimum amount of CET1 items that would be generated if the principal amount of the T2 instruments were fully written down or converted into CET1 instruments.
- CA-2.1.10J** The aggregate amount of T2 instruments that is required to be written down or converted upon the occurrence of a trigger event must be no less than the lower of the following:
- The amount required to restore fully the CET1 ratio of the Islamic bank licensee to 7.0 %; and
  - The full principal amount of the instrument.
- CA-2.1.10K** When a trigger event occurs Islamic bank licensees must do the following:
- Immediately inform the CBB;
  - Inform the holders of the T2 instruments; and
  - Write down the principal amount of the instruments, or convert the instruments into CET1 instruments without delay, but no later than within one month, in accordance with the requirement laid down in this Section.



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

## CA-2.1 Regulatory Capital (continued)

**CA-2.1.10L** An Islamic bank licensee issuing T2 instruments that convert to CET1 on the occurrence of a trigger event must ensure that its authorised share capital is at all times sufficient, for converting all such convertible T2 instruments into shares if a trigger event occurs.

**CA-2.1.10M** All necessary authorisations must be obtained at the date of issuance of such convertible T2 instruments. The Islamic bank licensee must maintain at all times the necessary prior authorisation from the CBB to issue the CET1 instruments into which such T2 instruments would convert upon occurrence of a trigger event.

**CA-2.1.10N** An Islamic bank licensee issuing T2 instruments that convert to CET1 on the occurrence of a trigger event must ensure that there are no procedural impediments to that conversion by virtue of its incorporation or statutes or contractual arrangements.

### *Consequences of the Conditions for T2 Instruments Ceasing to Be Met*

**CA-2.1.10O** The following must apply where, in the case of a T2 instrument, the conditions laid down in Paragraph CA-2.1.10 cease to be met:

- (a) That instrument must immediately cease to qualify as a T2 instrument; and
- (b) The part of the share premium accounts that relates to that instrument must immediately cease to qualify as a T2 item.

### *Treatment of PSIA, PER and IRR*

CA-2.1.11 Profit-sharing investment accounts of an Islamic bank licensee are not classified as part of the Islamic bank licensee's capital because they do not meet the above-mentioned criteria of T1 or T2 Capital. Furthermore, all the investment risk reserve (IRR) and a portion of the profit equalisation reserve (PER) belong to the equity of investment account holders, and thus are not part of the capital of the Islamic bank licensee. As the purpose of a PER is to smooth the profit payouts and not to cover losses, any portion of a PER that is part of the Islamic bank licensee's reserves should also not be treated as part of the regulatory capital of the Islamic bank licensee. The impact of PER and IRR has already been incorporated in the alpha component of the denominator of the formula for the calculation of the CAR, as outlined in Paragraph CA-1.1.12.



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

## CA-2.2 Limits and Minima on the Use of Different Forms of Capital

### *Consolidated T1 Capital and Total Capital*

#### CA-2.2.1

CAR components and CARs outlined in Paragraph CA-B.2.1 must meet or exceed the following minimum ratios on a consolidated basis relative to total risk-weighted assets:

- (a) CET1 must be at least 6.5% of risk-weighted assets at all times;
- (b) T1 Capital must be at least 8% of risk-weighted assets at all times;
- (c) Total Capital (T1 Capital plus T2 Capital) must be at least 10% of risk-weighted assets at all times;
- (d) In addition, Islamic bank licensees must meet the minimum Capital Conservation Buffer (CCB) requirement of 2.5% of risk-weighted assets. The CCB must be composed of CET1 and so this gives an aggregate 9% CET1 including the CCB minimum capital requirement;
- (e) A minimum 10.5% T1 Capital Adequacy Ratio including the above CCB requirement; and
- (f) A 12.5% minimum Total Capital Adequacy Ratio including the above CCB requirement.

### *Solo Tier 1 Capital and Total Capital*

#### CA-2.2.1A

CAR components and CARs outlined in Paragraph CA-B.2.1 must meet or exceed the following minimum ratios on a solo basis relative to total risk-weighted assets:

- (a) CET1 must be at least 4.5% of risk-weighted assets at all times;
- (b) T1 Capital must be at least 6% of risk-weighted assets at all times;
- (c) Total Capital (T1 Capital plus T2 Capital) must be at least 8% of risk-weighted assets at all times; and
- (d) The minimum Capital Conservation Buffer (CCB) requirement of 2.5% of risk-weighted assets does not apply on a solo basis.

#### CA-2.2.2

CET1 must be the predominant form of capital. Accordingly, the contribution of AT1 instruments towards the Minimum T1 Capital Ratios mentioned in Paragraphs CA-2.2.1 and CA-2.2.1A is limited to 1.5%.



|                |                                 |
|----------------|---------------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b>     |
| <b>CHAPTER</b> | <b>CA-2: Regulatory Capital</b> |

## **CA-2.2 Limits and Minima on the Use of Different Forms of Capital (continued)**

CA-2.2.3 The limits on AT1 instruments and T2 instruments are based on the amount of CET1 after deductions pursuant to CA-2.4 (see Appendices CA-11 and CA-12 for examples of the threshold deduction effects and the caps).

### *Tier 2: Supplementary Capital*

**CA-2.2.4** The contribution of T2 capital towards the Minimum Total Capital Ratios and Minimum Total Capital plus Capital Conservation Buffer Ratios mentioned in Paragraphs CA-2.2.1 (consolidated) and CA-2.2.1A (solo) is limited to 2.0%.

CA-2.2.5 To explain the limits outlined in Paragraph CA-2.2.4 on the contributions of AT1 and T2 Capital to T1 and Total Capital, a simple example is given below where an Islamic bank licensee on a consolidated basis has BD650mn of Core Equity Tier One Capital and BD200mn of AT1 and BD300mn of T1 Capital and BD10,000mn of total risk-weighted assets:

- (a) 6.5% CET1 = BD650mn;
- (b) 8.0% T1 = BD800mn (i.e. only BD150mn of the AT1 may be included in the T1 minimum requirement;
- (c) 10% Total Capital = BD1,000mn (i.e. only BD200mn of the T2 Capital may be included in the Total Capital requirement.

This means that if the Islamic bank licensee only has BD650mn of CET1, it cannot comply with the additional Capital Conservation Buffer Requirement of 2.5% nor can it use excess AT1 or T2 Capital to meet this requirement. Although it would appear that the Islamic bank licensee has BD1,150mn of total capital, only BD1,000mn can be used to meet the minimum ratios. This example serves to underline the importance of CET1. Unless an Islamic bank licensee can meet the CET1 minimum CARs of 6.5% and 9.0% mentioned above, it may not be able to meet any of the other minimum capital adequacy ratios outlined in Paragraph CA-2.2.1. A separate example of the effect of the T2 cap is given in Appendix CA-12.



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

### CA-2.3 Minority Interest Held by Third Parties in Consolidated Banking Subsidiaries

#### *Common Shares issued by Consolidated Banking Subsidiaries*

##### CA-2.3.1

In order for minority interest arising from the issue of common shares by a fully consolidated banking subsidiary of the Islamic bank licensee to be recognised in CET1 for the consolidated CAR calculation, it must meet the following conditions:

- (a) The instrument giving rise to the minority interest would, if issued by the Islamic bank licensee, meet all of the criteria for classification as common shares for regulatory capital purposes;
- (b) The subsidiary that issued the instrument is itself a bank<sup>1,2</sup>; and
- (c) The subsidiary meets the limits outlined in Paragraph CA-2.3.2.

##### CA-2.3.2

The amount of minority interest meeting the criteria above that will be recognised in consolidated CET1 will be calculated as follows:

- (a) Total minority interest meeting the criteria in Paragraph CA-2.3.1 minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders;
- (b) Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of:
  - (i) The minimum CET1 requirement of the subsidiary plus the capital conservation buffer (CCB) (i.e. 7.0% of risk weighted assets or more as required by the concerned supervisor); and
  - (ii) The portion of the consolidated minimum CET1 requirement plus the CCB (i.e. 9.0% of consolidated risk weighted assets) that relates to the subsidiary; and
- (c) The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.

CA-2.3.2A Appendix CA-1 outlines an example of the effect of the allocation of minority interest between the parent bank and minority shareholders in the fully consolidated subsidiary.

<sup>1</sup> For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.

<sup>2</sup> Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.



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

### CA-2.3 Minority Interest Held by Third Parties in Consolidated Banking Subsidiaries (continued)

#### *AT1 Qualifying Capital issued by Consolidated Banking Subsidiaries*

##### CA-2.3.3

AT1 capital instruments issued by a fully consolidated banking subsidiary of the Islamic bank licensee to third party investors (including amounts under Paragraph CA-2.3.2) may receive recognition in consolidated T1 capital only if the instruments would, if issued by the Islamic bank licensee, meet all of the criteria for classification as T1 capital. The amount of this AT1 capital that will be recognised in consolidated AT1 will exclude amounts recognised in consolidated CET1 under Paragraph CA-2.3.2 and will be calculated as follows:

- (a) T1 of the banking subsidiary issued to third parties minus the amount of the surplus T1 of the subsidiary attributable to the third party investors;
- (b) Surplus T1 of the banking subsidiary is calculated as the T1 of the subsidiary minus the lower of: (1) the minimum T1 requirement of the banking subsidiary plus the CCB and (2) the portion of the consolidated minimum T1 requirement plus the CCB that relates to the subsidiary; and
- (c) The amount of the surplus T1 that is attributable to the third party investors is calculated by multiplying the surplus T1 by the percentage of T1 that is held by third party investors.

#### *T2 Qualifying Capital issued by Consolidated Subsidiaries*

##### CA-2.3.4

T2 capital instruments issued by a fully consolidated banking subsidiary of the Islamic bank licensee to third party investors (including amounts under Paragraphs CA-2.3.2 and CA-2.3.3) may receive recognition in consolidated Total Capital only if the instruments would, if issued by the Islamic bank licensee, meet all of the criteria for classification as T2 capital. The amount of this T2 capital that will be recognised in the parent bank's T2 will exclude amounts recognised in CET1 under Paragraph CA-2.3.2 and amounts recognised in AT1 under Paragraph CA-2.3.3 and will be calculated as follows:

- (a) Total capital instruments of the banking subsidiary issued to third parties minus the amount of the surplus Total Capital of the banking subsidiary attributable to the third party investors;



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

### CA-2.3 Minority Interest Held by Third Parties in Consolidated Banking Subsidiaries (continued)

- (b) Surplus Total Capital of the banking subsidiary is calculated as the Total Capital of the banking subsidiary minus the lower of:
  - (i) The minimum Total Capital requirement of the subsidiary plus the capital conservation buffer; and
  - (ii) The portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer that relates to the banking subsidiary; and
- (c) The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

#### CA-2.3.5

Where capital has been issued to third parties out of a special purpose vehicle (SPV), none of this capital can be included in consolidated CET1. However, such capital can be included in consolidated AT1 or T2 and treated as if the Islamic bank licensee itself had issued the capital directly to the third parties only if it meets all the relevant entry criteria and the only asset of the SPV is its investment in the capital of the Islamic bank licensee in a form that meets or exceeds all the relevant entry criteria<sup>3</sup> (as required by CA-2.1.5(r) for AT1 and CA-2.1.8(i) for T2). In cases where the capital has been issued to third parties through an SPV via a fully consolidated subsidiary of the Islamic bank licensee, such capital may, subject to the requirements of this Paragraph, be treated as if the banking subsidiary itself had issued it directly to the third parties and may be included in the Islamic bank licensee's consolidated AT1 or T2 in accordance with the treatment outlined in Paragraphs CA-2.3.3 and CA-2.3.4.

<sup>3</sup> Assets that relate to the operation of the SPV may be excluded from this assessment if they are de minimis.



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

## CA-2.4 Regulatory Adjustments (Solo and Consolidated)

### CA-2.4.1

This section sets out the regulatory adjustments to be applied to Regulatory Capital. There are four stages of adjustments for CET1. In most cases these adjustments are applied in the calculation of CET1. The first set of adjustments is applied in Paragraphs CA-2.4.2 to CA-2.4.15. A subtotal for CET1 is obtained (this can be called CET1a). A second regulatory adjustment described in Paragraphs CA-2.4.16 to CA-2.4.19 is then applied to CET1a (this adjustment results in CET1b). A third regulatory adjustment described in Paragraphs CA-2.4.20 to CA-2.4.21 is then applied to CET1b (this adjustment results in CET1c). Then a final regulatory adjustment described in Paragraph CA-2.4.23 is then applied to CET1c (this adjustment results in CET1d). This is the amount of CET1 that can be used for the calculation of the CAR and determining all other applicable caps on T1 and T2. An example of the effects of the regulatory deductions is given in Appendix CA-11.

### *Goodwill and other Intangibles (except Mortgage Servicing Rights)*

### CA-2.4.2

Goodwill must be deducted in the calculation of CET1, including any goodwill included in the valuation of significant investments in the capital of banking, financial and Takaful entities that are outside the scope of regulatory consolidation. The full amount is to be deducted net of any associated deferred tax liability which would be extinguished if the goodwill becomes impaired or derecognised under IFRS or AAOIFI. The amount to be deducted in respect of mortgage servicing rights is set out in Paragraph CA-2.4.23A. Intangible assets other than goodwill and mortgage service rights are subject to transitional arrangements and are phased out as regulatory adjustments as outlined in Subparagraph CA-B.2.1(d).

### CA-2.4.3

Islamic bank licensees must use the IFRS or AAOIFI definitions (as applicable) of intangible assets to determine which assets are classified as intangible and are thus required to be deducted.



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

## CA-2.4 Regulatory Adjustments (continued)

### *Deferred Tax Assets*

**CA-2.4.4** Deferred tax assets (DTAs) that rely on future profitability of the Islamic bank licensee to be realised are to be deducted in the calculation of CET1. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. Where these DTAs relate to temporary differences (e.g. allowance for credit losses) the amount to be deducted is set out in Paragraph CA-2.4.23. All other such assets, e.g. those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment and DTAs that are to be deducted in full.

**CA-2.4.5** An over instalment of tax or, in some jurisdictions, current year tax losses carried back to prior years may give rise to a claim or receivable from the government or local tax authority. Such amounts are typically classified as current tax assets for accounting purposes. The recovery of such a claim or receivable would not rely on the future profitability of the Islamic bank licensee and must be assigned the relevant sovereign risk weighting.

### *Cash Flow Hedge Reserve*

**CA-2.4.6** The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) must be derecognised in the calculation of CET1. This means that positive amounts must be deducted and negative amounts must be added back.

**CA-2.4.7** This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognised for prudential purposes. It removes the element that gives rise to artificial volatility in common equity, as in this case the reserve only reflects one half of the picture (the fair value of the Shari'a compliant hedging contracts, but not the changes in fair value of the hedged future cash flow).



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

## CA-2.4 Regulatory Adjustments (continued)

### *Gain on Sale Related to Securitisation Transactions*

#### CA-2.4.8

Any increase in equity capital resulting from a securitisation transaction (see Chapter CA-8) must be deducted from the calculation of CET1.

#### CA-2.4.9

[This paragraph has been left blank.]

### *Defined Benefit Pension Fund Assets and Liabilities*

#### CA-2.4.10

Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognised in the calculation of CET1 (i.e. CET1 cannot be increased through derecognising these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the asset must be deducted in the calculation of CET1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or derecognised under the relevant accounting standards. Assets in the fund to which the Islamic bank licensee has unrestricted and unfettered access can, with supervisory approval, offset the deduction. Such offsetting assets must be given the risk weight they would receive if they were owned directly by the Islamic bank licensee.

#### CA-2.4.11

Paragraph CA-2.4.10 only applies to Islamic bank licensees which have subsidiaries which are located in jurisdictions where there are defined benefit pension schemes and addresses the concern that assets arising from pension funds may not be capable of being withdrawn and used for the protection of depositors and other creditors of a bank. The concern is that their only value stems from a reduction in future payments into the fund. The treatment allows for banks to reduce the deduction of the asset if they can address these concerns and show that the assets can be easily and promptly withdrawn from the fund.



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

## CA-2.4 Regulatory Adjustments (continued)

### *Investments in Own Shares*

#### CA-2.4.12

All of an Islamic bank licensee's investments in its own common shares, whether held directly or indirectly must be deducted in the calculation of CET1. In addition, any own stock which the Islamic bank licensee could be contractually obliged to purchase must be deducted in the calculation of CET1. The treatment described applies irrespective of the location of the exposure in the banking book or the trading book. In addition:

- (a) Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk (i.e. this would normally mean that the long and short positions are with the same counterparty and a valid close-out netting agreement is in place);
- (b) Islamic bank licensees must look through holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short positions in own shares resulting from short positions in the same underlying index where they are undertaken with the same counterparty. In such cases the short positions may still involve counterparty risk (which is subject to the relevant counterparty credit risk charge); and
- (c) Any shares of the Islamic bank licensee held as collateral against exposures to customers are considered to be held indirectly and are subject to deduction.

#### CA-2.4.13

The deduction under Paragraph CA-2.4.12 is necessary to avoid the double counting of an Islamic bank licensee's own capital. The treatment seeks to remove the double counting that arises from direct holdings, indirect holdings via index funds and potential future holdings as a result of contractual obligations to purchase own shares.

#### CA-2.4.14

Islamic bank licensees must deduct investments in their own AT1 in the calculation of their AT1 capital and must deduct investments in their own T2 in the calculation of their T2 capital.



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

## CA-2.4 Regulatory Adjustments (continued)

### *Reciprocal Cross Holdings in the Capital of Banking and Financial Entities*

#### CA-2.4.15

Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of Islamic bank licensees will be deducted in full. Islamic bank licensees must apply a “corresponding deduction approach” to such investments in the capital of other banks and other financial entities. This means the deduction must be applied to the same component of capital for which the capital would qualify if it was issued by the Islamic bank licensee itself. The above adjustments (CA-2.4.2 to CA-2.4.15) must now be aggregated and applied to CET1 to obtain a subtotal (CET1a). This new adjusted CET1a is used for the purpose of calculating the next adjustment.

*Investments in the capital of banking and financial entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity*

#### CA-2.4.16

The regulatory adjustment described in Paragraph CA-2.4.17 applies to investments in the capital of banking and financial entities that are outside the scope of regulatory consolidation and where the Islamic bank licensee does not own more than 10% of the issued common share capital of the entity. In addition:

- (a) Investments include direct and indirect<sup>4</sup> holdings of capital instruments. For example, Islamic bank licensees must look through holdings of index securities to determine their underlying holdings of capital;<sup>5</sup>
- (b) Holdings in both the banking book and trading book must be included. Capital includes common stock and all other types of capital instruments. It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year);

<sup>4</sup> Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

<sup>5</sup> If banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions as a result of their holdings of index securities, banks must risk weight all such holdings in funds at 1,250% as per the ‘fall-back approach’ outlined in the Basel Committee document “Capital requirements for banks’ equity investments in funds - final standard” dated December 2013.



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

## CA-2.4 Regulatory Adjustments (continued)

- (c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included; and
- (d) If the capital instrument of the entity in which the Islamic bank licensee has invested does not meet the criteria for CET1, AT1, or T2 (see CA-2.1.2(f)) of the concerned bank, the capital is to be considered common shares for the purposes of this regulatory adjustment. However, if the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant jurisdiction of the financial entity, it is not required to be deducted.

### CA-2.4.17

If the total of all holdings listed in Paragraph CA-2.4.16 in aggregate exceed 10% of the Islamic bank licensee's CET1a (i.e. after applying all other regulatory adjustments from Paragraph CA-2.4.2 to Paragraph CA-2.4.15) then the amount above 10% is required to be deducted, applying a corresponding deduction approach. This means the deduction must be applied to the same component of capital for which the capital would qualify if it was issued by the Islamic bank licensee itself. Accordingly, the amount to be deducted from CET1a must be calculated as the total of all holdings which in aggregate exceed 10% of the Islamic bank licensee's CET1a (as per above) multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a CET1a deduction which corresponds to the proportion of total capital holdings held in CET1a. Similarly, the amount to be deducted from AT1 capital must be calculated as the total of all holdings which in aggregate exceed 10% of the Islamic bank licensee's CET1a (as per above) multiplied by the AT1 capital holdings as a percentage of the total capital holdings. The amount to be deducted from T2 capital must be calculated as the total of all holdings which in aggregate exceed 10% of the Islamic bank licensee's CET1a (as per above) multiplied by the T2 capital holdings as a percentage of the total capital holdings.

### CA-2.4.18

See Paragraph CA-2.4.21 for further details on what to do if, under the corresponding deduction approach, an Islamic bank licensee is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction.



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

## CA-2.4 Regulatory Adjustments (continued)

### CA-2.4.19

Amounts below the threshold, which are not deducted, will continue to be risk weighted. Thus, instruments in the trading book will be treated as per the market risk rules and instruments in the banking book must be treated as per Chapter CA-5. For the application of risk weighting the amount of the holdings must be allocated on a pro rata basis between those below and those above the threshold. The above adjustments (CA-2.4.16 to CA-2.4.18) must now be aggregated and applied to CET1a to obtain a new subtotal (CET1b). This new adjusted CET1b is used for the purpose of calculating the next adjustment.

*Significant Investments in the Capital of Banking and Financial Entities that are Outside the Scope of Regulatory Consolidation<sup>6</sup>*

### CA-2.4.20

The regulatory adjustment described in Paragraph CA-2.4.21 applies to investments in the capital of banking and financial entities that are outside the scope of regulatory consolidation where the Islamic bank licensee owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the Islamic bank licensee. In addition:

- (a) Investments include direct and indirect holdings of capital instruments. For example, Islamic bank licensees must look through holdings of index securities to determine their underlying holdings of capital;<sup>7</sup>
- (b) Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of capital instruments. It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year);
- (c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included; and

<sup>6</sup> Investments in entities that are outside the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.

<sup>7</sup> If banks find it operationally burdensome to look through and monitor their exact exposure to the capital of other financial institutions as a result of their holdings of index securities, the CBB may permit banks, subject to prior CBB approval, to use a conservative estimate.



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

## CA-2.4 Regulatory Adjustments (continued)

- (d) If the capital instrument of the entity in which the Islamic bank licensee has invested does not meet the criteria for CET1, AT1, or T2 capital (see CA-2.1.2(f)) of the concerned bank, the capital is to be considered common shares for the purposes of this regulatory adjustment. However, if the investment is issued out of a regulated financial entity and not included in regulatory capital of the financial entity, it is not required to be deducted.

### CA-2.4.21

All investments in Paragraph CA-2.4.20 that are not common shares must be fully deducted following a corresponding deduction approach. This means the deduction must be applied to the same tier of capital for which the capital would qualify if it was issued by the Islamic bank licensee itself. If the Islamic bank licensee is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital (e.g. if an Islamic bank licensee does not have enough AT1 capital to satisfy a particular deduction, the shortfall will be deducted from CET1c).

### CA-2.4.22

Investments in Paragraph CA-2.4.20 that are common shares are subject to the threshold treatment described in Paragraph CA-2.4.23. The above adjustments (CA-2.4.20 to CA-2.4.21) must be aggregated and applied to CET1b to obtain a new subtotal (CET1c). This new adjusted CET1c is used for the purpose of calculating the next adjustment.

### *Threshold Deductions*

### CA-2.4.23

If the total of all common equity holdings listed in Paragraph CA-2.4.20 in aggregate exceeds 10% of the Islamic bank licensee's CET1c, then the amount above 10% is required to be deducted from CET1c (see Appendices CA-11 and CA-12 for examples). After this deduction, the Islamic bank licensee must deduct the amount by which each of items b) and c) in Paragraph CA-2.4.23A individually exceeds 10% of its CET1c. After these individual deductions, the aggregate of the three items below which exceeds 15% of CET1c (calculated prior to the deduction of these items but after application of all other regulatory adjustments to CET1 applied in Paragraphs CA-2.4.2 to CA-2.4.21) must be deducted from CET1c. The adjustments in this Paragraph are applied to CET1c to obtain a new subtotal (CET1d). This new adjusted CET1d is used for calculating the consolidated CAR and the applicable caps on AT1 and T2. The items included in the 15% aggregate limit are subject to full disclosure.



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

## CA-2.4 Regulatory Adjustments (continued)

**CA-2.4.23A** As of 1 January 2020, the calculation of the 15% limit will be subject to the following treatment: the sum of the three items below that remains recognised after the application of all regulatory adjustments must not exceed 15% of CET1d (See Appendix CA-3 for an example):

- (a) Significant investments in the common shares of unconsolidated banks and other financial entities) as referred to in Paragraph CA-2.4.20;
- (b) Mortgage servicing rights (MSRs); and
- (c) Deferred Tax Assets (DTAs) that arise from temporary differences.

**CA-2.4.24** The amount of the three above items that are not deducted in the calculation of CET1d is risk weighted at 250% (see Paragraph CA-3.2.26).

### *Former Deductions from Capital*

**CA-2.4.25** The following items receive the following risk weights:

- (a) Certain securitisation and Sukuk exposures outlined in Chapter CA-8: 1,250%;
- (b) Non-payment/delivery on non-DvP and non-PvP transactions (see Appendix CA-4): 1,250%;
- (c) The amount of any significant investments in commercial entities, as defined in Paragraph CM-4.10.5, which exceed the materiality is risk weighted at 800%. The materiality thresholds for these investments are: 15% of Total Capital for individual significant investments; and 60% of Total Capital for the aggregate of such investments; and
- (d) Any exposures above the large exposures limits set by the CBB in Chapter CM-4 of the CBB Rulebook: 800%.

**CA-2.4.26** For Subparagraphs CA-2.4.25 (c) and (d), amounts below the materiality thresholds and large exposure limits continue to be risk weighted in accordance with Chapter CA-3. Where the remaining holdings are made up of holdings carrying different risk weights, the application of the risk weighting must be allocated on a pro rata basis for those exposures that are not subject to the 800% risk weight. Appendix CA-10 gives an example of the way to calculate the risk weighted assets and the effect of the limits outlined in Subparagraphs CA-2.4.25 (c) and (d).



|         |        |                             |
|---------|--------|-----------------------------|
| MODULE  | CA:    | Capital Adequacy            |
| CHAPTER | CA-2A: | Capital Conservation Buffer |

## CA-2A.1 Capital Conservation Best Practice

CA-2A.1.1 This section outlines the operation of the capital conservation buffer, which is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements.

**CA-2A.1.2** Outside of periods of stress, Islamic bank licensees must hold buffers of capital above the regulatory minimum.



|         |                                    |
|---------|------------------------------------|
| MODULE  | CA: Capital Adequacy               |
| CHAPTER | CA-2A: Capital Conservation Buffer |

## CA-2A.2 The Capital Conservation Buffer Requirement

### CA-2A.2.1

Islamic bank licensees are required to hold a capital conservation buffer of 2.5%, comprised of CET1 above the regulatory minimum Total Capital ratio of 10%.<sup>8</sup> Any capital raised through the issuance of Sukuk cannot be considered a part of the buffer as Sukuk do not qualify for inclusion in CET1. Capital distribution constraints will be imposed on an Islamic bank licensee when the CCB falls below 2.5%. The constraints imposed only relate to distributions, not the operation of the Islamic bank licensee.

### CA-2A.2.2

Islamic bank licensees must note that they are required to maintain a minimum consolidated Total Capital Ratio of 12.5% and a solo Total Capital Ratio of 8% regardless of whether they do or do not have AT1 or T2 Capital and therefore Islamic bank licensees will be required to retain 100% of the annual net profit unless their consolidated Total Capital Ratio is above 12.5% and their solo Total Capital Ratio is above 8%.

### CA-2A.2.3

Elements subject to the restriction on distributions: Items considered to be distributions include dividends and share buybacks, discretionary profit distributions on other T1 capital instruments and discretionary bonus payments to staff. Payments that do not result in a depletion of CET1, which may for example include certain scrip dividends, are not considered distributions.

<sup>8</sup> Common Equity Tier 1 must first be used to meet the minimum capital requirements (including the 8% T1 and 10% Total Capital requirements if necessary), before the remainder can contribute to the capital conservation buffer.



|                |                                           |
|----------------|-------------------------------------------|
| <b>MODULE</b>  | <b>CA: Capital Adequacy</b>               |
| <b>CHAPTER</b> | <b>CA-2A: Capital Conservation Buffer</b> |

## **CA-2A.2 The Capital Conservation Buffer Requirement (continued)**

### *Capital Conservation Plan*

#### **CA-2A.2.4**

Where an Islamic bank licensee fails to meet the required level of capital conservation buffer, it must prepare a Capital Conservation Plan (hereinafter referred to as “Plan”) clearly outlining the information mentioned in this Paragraph. The Islamic bank licensee must submit this Plan to the CBB within one week of becoming aware of the shortfall (see also CA-1.2.2). The Islamic bank licensee must already have prepared such a Plan on a contingency basis. The Plan must include the following:

- (a) Estimates of income and expenditure and a forecasted balance sheet;
- (b) Measures to be taken to increase the Islamic bank licensee’s capital ratios;
- (c) A plan and time frame for the increase of capital with the objective of meeting fully the buffer requirement; and
- (d) Any other information the CBB deems necessary to carry out the assessment required, as indicated in Paragraph CA-2A.2.5.

#### **CA-2A.2.5**

The CBB shall review the Plan submitted by the Islamic bank licensee and shall approve it provided it considers that the Plan provides a reasonable basis for conserving or raising sufficient capital that will enable the Islamic bank licensee to meet the buffer requirements within a period acceptable to the CBB. While reviewing the Plan, the CBB will also evaluate whether the Islamic bank licensee has deliberately reduced its CET1 so as to operate in the buffer range (i.e. below the capital conservation buffer requirement) in order to reduce its cost of capital for competitive purposes.

#### **CA-2A.2.6**

If the Plan is not approved by the CBB, it may take one or more of the following steps, inter alia, as deemed necessary:

- (a) Ask the Islamic bank licensee to revise the Plan and resubmit it within a specified time period;
- (b) Require the Islamic bank licensee to raise new capital from private sources to specified levels within specified periods; or
- (c) Impose more stringent restrictions on distributions than those required by Paragraph CA-2A.2.3.



|         |                                    |
|---------|------------------------------------|
| MODULE  | CA: Capital Adequacy               |
| CHAPTER | CA-2A: Capital Conservation Buffer |

### CA-2A.3 Implementation Date

**CA-2A.3.1** The capital conservation buffer will be implemented on 1 January 2015. It will be set at 2.5% of RWAs.

**CA-2A.3.2** Islamic bank licensees must maintain prudent earnings retention policies with a view to meeting the conservation buffer at all times.

**CA-2A.3.3** [This Paragraph was deleted in April 2015.]

CA-2A.3.4 The CBB will issue rules and guidance on the countercyclical buffer in due course. The CBB reserves the right to use its discretion on the timing and amount of the countercyclical buffer, depending on economic conditions in the region and globally.