



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Capital Adequacy Framework (Operational Risk)

Applicable to:

1. Licensed banks
2. Licensed investment banks
3. Licensed Islamic banks
4. Financial holding companies

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PART A OVERVIEW

1 Introduction

- 1.1 This policy document sets out the standards and guidance for the calculation of a financial institution's operational risk-weighted assets under the Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks. These requirements are broadly in line with the Basel III standards set by the Basel Committee on Banking Supervision (BCBS)¹ and the capital standards issued by the Islamic Financial Services Board (IFSB)², and have been modified accordingly where applicable.
- 1.2 The provisions on (i) the applicability of this policy document, (ii) legal provisions pursuant to which this policy document is issued, (iii) terms and expressions used in this policy document, (iv) the related legal instruments and policy documents, and (v) level of application of this policy document shall be as follows:

Policy Document	Paragraph
<i>Capital Adequacy Framework (Capital Components)</i> issued on 15 December 2023 and as may be amended by the Bank (hereinafter "CAF CC PD")	<ul style="list-style-type: none"> • Paragraph 2 on 'Applicability' • Paragraph 3 on 'Legal Provisions' • Paragraph 5 of 'Interpretation' subject to the modifications in paragraph 3 of this policy document • Paragraph 6 on 'Related legal instruments and policy documents', subject to the modifications in paragraph 1.3 of this policy document • Paragraph 8 on 'Level of application'
<i>Capital Adequacy Framework for Islamic Banks (Capital Components)</i> issued on 15 December 2023 and as may be amended by the Bank (hereinafter "CAFIB CC PD")	<ul style="list-style-type: none"> • Paragraph 2 on 'Applicability' • Paragraph 3 on 'Legal Provisions' • Paragraph 5 of 'Interpretation' subject to the modifications in paragraph 3 of this policy document • Paragraph 6 on 'Related legal instruments and policy documents', subject to the modifications in paragraph 1.3 of this policy document • Paragraph 8 on 'Level of application'

¹ *Basel III: Finalising Post-Crisis Reforms*, December 2017 (<https://www.bis.org/bcbs/publ/d424.pdf>)

² *IFSB 23: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services* (https://www.ifsb.org/wp-content/uploads/2023/10/IFSB-23_En.pdf)

- 1.3 This policy document must be read together with the policy documents as set out in paragraph 1.2, and other relevant legal instruments, policy documents and guidelines that have been issued by the Bank, including any amendments or reissuance thereafter, including *Operational Risk Reporting* (ORR) issued on 1 November 2023.

2 Effective date

- 2.1 This policy document will come into effect on 1 January 2025.

3 Interpretation

- 3.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the Financial Services Act 2013 (FSA), Islamic Financial Services Act 2013 (IFSA), CAF CC PD and CAFIB CC PD, as the case may be, unless otherwise defined in this policy document–

“**financial institution**” refers to both a financial institution as defined in CAF CC PD and an Islamic financial institution as defined in CAFIB CC PD.

4 Policy documents superseded

- 4.1 This policy document supersedes Part C of the *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* and *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)* issued on 3 May 2019.

PART B POLICY REQUIREMENTS

5 Total operational risk-weighted assets

- S** 5.1 A financial institution shall calculate its total operational risk-weighted assets (RWA_{OR}) as follows:

$$RWA_{OR} = K_{ORC} \times 12.5$$

where –

K_{ORC} is the operational risk capital requirements as set out in paragraph 5.2.

- S** 5.2 A financial institution shall calculate its operational risk capital requirements (K_{ORC}) as follows:

$$K_{ORC} = BIC \times ILM$$

where –

- (a) BIC is the Business Indicator Component, as set out in paragraph 6.7; and
- (b) ILM is the Internal Loss Multiplier, as set out in paragraph 7.

6 Business Indicator Component

- S** 6.1 The BIC in paragraph 5.2 shall be a function of two elements:
- (a) the Business Indicator (BI), which is set out in paragraph 6.2; and
 - (b) α which is the marginal coefficient to be applied based on the value of the BI, as set out in paragraph 6.7.

- S** 6.2 A financial institution shall calculate the BI as follows:

$$BI = IPC + SC + FC$$

where –

- (a) IPC is the Interest/Profit Component;
- (b) SC is the Services Component; and
- (c) FC is the Financial Component.

These components shall be calculated in accordance with paragraph 6.3.

- S** 6.3 A financial institution shall calculate the IPC, SC and FC components as follows:

- (a) $IPC = \text{Min} \left[\frac{\text{Abs}(\text{interest income} + \text{profit income} - \text{interest expense} - \text{profit payable})}{\text{interest earning assets} + \text{profit earning assets}}, 2.25\% \right] + \frac{\text{dividend income}}{\text{interest earning assets} + \text{profit earning assets}}$

$$(b) \quad \mathbf{SC} = \text{Max} \left[\overline{\text{other operating income}}, \overline{\text{other operating expense}} \right] + \text{Max} \left[\overline{\text{fee income}}, \overline{\text{fee expense}} \right]$$

$$(c) \quad \mathbf{FC} = \overline{\text{Abs(Net P\&L trading book)}} + \overline{\text{Abs(Net P\&L banking book)}}$$

where –

- (i) *Abs ()* is the absolute value of the item within the brackets;
- (ii) The income statement items refer to the quarterly value (as recorded in the financial institution's quarterly interim financial reports), and the balance sheet items³ refer to the carrying amount at the end of quarter, over the preceding twelve financial quarters⁴; and
- (iii) A bar above the term indicates that the term is to be calculated as an annualised three-year average⁵.

S 6.4 In calculating the components in paragraph 6.3, a financial institution shall comply with the additional requirements under Appendix 1⁶.

S 6.5 Where a financial institution has acquired a business or merged with another entity, the financial institution shall include the BI of the acquired business or merged entity (as at prior to the effective date of the acquisition or merger) over the period that is relevant to the calculation of the BI under paragraph 6.2.

S 6.6 Unless otherwise approved by the Bank, a financial institution which has transferred a business⁷ or divested its shareholding in an entity to any other person shall continue to include the BI of the transferred business or business of the entity in which the financial institution had divested its shareholding over the relevant period of its calculation of the BI under paragraph 6.2.

S 6.7 A financial institution shall compute the BIC referred to in paragraph 6.1 as follows:

$$\mathbf{BIC} = \sum_i (\mathbf{BI} \times \alpha_i)$$

where –

- (i) \sum is the sum of the items within the brackets for all buckets, *i*; and

³ Interest-earning assets and profit-earning assets.

⁴ Income statement and balance sheet items are categorised into 12 quarters (equivalent to 3 years) consistent with the approach that had been adopted under Capital Adequacy Framework (Basel II – Risk-Weighted Assets) and Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets), or as may be amended or modified by the Bank.

⁵ A newly established financial institution which has been in operation for less than three years should calculate the IPC, SC and FC over the entire period since it commenced operations, with the components annualised accordingly.

⁶ Appendix 1 sets out the descriptions and examples of BI components, and the items to be excluded from the BI.

⁷ For avoidance of doubt, this is referring to the transfer of business of a financial institution that falls under section 100 of the FSA or section 112 of the IFSA, as the case may be.

- (ii) $BI \times \alpha$ is computed for each bucket, i , by multiplying the BI by the corresponding marginal coefficients that are assigned to each BI range in accordance with the table below:

Bucket, i	BI range (RM billion)	BI marginal coefficients, α
1	≤ 1	12%
2	$1 < BI \leq 30$	15%
3	> 30	18%

- G** 6.8 The BI marginal coefficients increase with the size of the BI. For financial institutions in the first bucket (i.e. with a BI of less than or equal to RM1 billion), the BIC is equal to $BI \times 12\%$. The marginal increase in the BIC resulting from a one unit increase in the BI is 12% for Bucket 1, 15% for Bucket 2 and 18% for Bucket 3. For example, given a BI = RM35 billion:

$$\text{BIC} = (1 \times 12\%) + [(30-1) \times 15\%] + [(35-30) \times 18\%] = \text{RM5.37 billion}$$

7 Internal Loss Multiplier (ILM)

- S** 7.1 Unless otherwise specified by the Bank, a financial institution shall set the ILM⁸ as 1.
- S** 7.2 Where the Bank specifies that a financial institution shall observe an ILM of greater than 1 after having regard to the operational risk profile of the financial institution and the adequacy of the risk mitigation measures that have been put in place, the financial institution shall comply with the specification.

⁸ The financial institution's internal operational risk loss experience may affect the calculation of operational risk capital requirements through the ILM. In the event the Bank allows the application of internal operational risk loss data, such loss data must comply with the requirements of ORR.

APPENDIX 1 DEFINITION OF COMPONENTS OF THE BUSINESS INDICATOR

- S** 1. A financial institution shall calculate components of the BI based on the descriptions provided in the tables below⁹.
- G** 2. Non-exhaustive lists of examples of relevant sub-items from the income statement or balance sheet are also provided for guidance.
- S** 3. Unless otherwise stated, the measurement of the items under Tables 1, 2 and 3 below shall be in accordance with the relevant Malaysian Financial Reporting Standards (MFRS).

Table 1: Interest/Profit component (IPC)

Items	Description	Examples
(a) Interest income	Interest income from all financial assets and other interest income. This includes interest income from financial and operating leases, and profits from leased assets.	<ul style="list-style-type: none"> Interest income from loans and advances, assets at fair value through profit or loss, assets at fair value through other comprehensive income, assets at amortised cost, trading assets, financial leases and operational leases Interest income from hedge accounting derivatives Other interest income Profits from leased assets
(b) Profit income ¹⁰	Profit income from all financing, financial assets and other profit income. This includes profit income from leases/ <i>ijarah</i> contracts and investment accounts.	<ul style="list-style-type: none"> Profit income from all financing, assets at fair value through profit or loss, assets at fair value through other comprehensive income, assets at amortised cost, trading assets, leases/<i>ijarah</i> contracts Profit income from hedge accounting derivatives Other profit income not included in the above categories Profit share/<i>wakalah</i> fees income from investment accounts Profits from leased assets

⁹ This includes the clarifications set out in the Capital Adequacy Framework (Operational Risk) reporting template.

¹⁰ For Islamic banking operations. Any Shariah non-compliant sources of income shall be included under 'Other operating income' (See Item (c) under Table 2 below).

(c) Interest expenses	<p>Interest expenses from all financial liabilities and other interest expenses.</p> <p>This includes interest expense from financial and operating leases, depreciation and impairment of, as well as losses from, operating leased assets.</p>	<ul style="list-style-type: none"> • Interest expenses from deposits, debt securities issued, financial leases, and operating leases • Interest expenses from hedge accounting derivatives • Other interest expenses • Losses from leased assets • Depreciation and impairment of operating leased assets
(d) Profit payable ¹¹	<p>Profit payments on all financial liabilities and other return payments.</p> <p>This includes depreciation and impairment of, as well as losses from, leased assets.</p>	<p>Expenses or returns payable on funds received from investment account holders, current account deposits, <i>sukuk</i> issued, <i>ijarah</i>/leases contracts</p>
(e) Interest-earning assets	<p>This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing loans).</p>	<p>Total gross outstanding loans, advances, interest-bearing securities (including government bonds), leased assets</p>
(f) Profit-earning assets ¹¹	<p>This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing financing).</p>	<p>Total gross outstanding financing, <i>sukuk</i>, other profit-bearing financial assets (including sovereign <i>sukuk</i>), leased assets</p>
(g) Dividend income	<p>Dividend income from investments in stocks and funds not consolidated in the financial institution's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures.</p>	

¹¹ For Islamic banking operations.

Table 2: Services component (SC)

Items	Description	Examples
(a) Fee and commission income	<p>Income received from providing advice and services.</p> <p>This includes fees received by the financial institution for the supply of financial services.</p>	<p>Fee and commission income from:</p> <ul style="list-style-type: none"> • Securities (issuance, origination, reception, transmission, execution of orders on behalf of customers) • Clearing and settlement • Asset management • Custody • Fiduciary transactions • Payment services • Structured finance • Securitisations • Loan/financing commitments and guarantees • Foreign transactions
(b) Fee and commission expenses	<p>Expenses paid for receiving advice and services.</p> <p>This includes outsourcing fees paid by the financial institution for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services (e.g. logistical, IT, human resources).</p>	<p>Fee and commission expenses from:</p> <ul style="list-style-type: none"> • Securities (issuance, origination, reception, transmission) • Clearing and settlement • Asset management • Custody • Fiduciary transactions • Payment services • Structured finance • Securitisations • Loan/financing commitments and guarantees • Foreign transactions
(c) Other operating income	<p>Income from ordinary banking operations not included in other BI items.</p> <p>This excludes income from operating leases.</p>	<ul style="list-style-type: none"> • Rental income from investment properties • Gains from non-current assets and disposal groups classified as held for sale that do not qualify as discontinued operations (MFRS 5.37) • For Islamic banking operations, income from non-Shariah compliant sources, if any
(d) Other operating expenses	<p>Expenses and losses from ordinary banking operations not included in other BI items, but of a similar nature and</p>	<ul style="list-style-type: none"> • Losses from non-current assets and disposal groups classified as held for sale that do not qualify as discontinued operations (MFRS 5.37)

	<p>stemming from operational loss events.</p> <p>This excludes expenses from operating leases.</p>	<ul style="list-style-type: none"> • Losses incurred as a consequence of operational loss events (e.g. fines, penalties, settlements, replacement cost of damaged assets), which have not been previously provisioned/reserved for • Expenses related to establishing provisions/reserves for operational loss events
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Table 3: Financial component (FC)

Items	Examples
(a) Net profit/loss on the trading book	<ul style="list-style-type: none"> • Net profit/loss on trading assets and trading liabilities (including derivatives, debt securities/<i>sukuk</i>, equity securities, loans and advances, short positions, other assets and liabilities) • Net profit/loss from hedge accounting • Net profit/loss from exchange differences
(b) Net profit/loss on the banking book	<ul style="list-style-type: none"> • Net profit/loss on financial assets and liabilities measured at fair value through profit and loss • Realised gains/losses on financial assets and liabilities not measured at fair value through profit and loss (including loans and advances, assets at fair value through other comprehensive income, assets at amortised cost, financial liabilities measured at amortised cost) • Net profit/loss from hedge accounting • Net profit/loss from exchange differences

Excluded items

A financial institution shall exclude the following items from the BI calculation:

- (a) income and expenses from insurance/takaful or reinsurance/retakaful businesses;
- (b) premiums/contributions paid and reimbursements/payments received from insurance/takaful or reinsurance/retakaful policies/certificates purchased;
- (c) administrative expenses, including staff expenses, outsourcing fees paid for the supply of non-financial services (e.g. logistical, IT, human resources) and other administrative expenses (e.g. IT, utilities, telecommunications, travel, office supplies, postage);
- (d) recovery of administrative expenses including recovery of payments on behalf of customers (e.g. taxes debited to customers);
- (e) expenses of premises and fixed assets (except when these expenses result from operational loss events);

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- (f) depreciation/amortisation of tangible and intangible assets (except depreciation related to operating lease assets, which should be included in financial and operating lease expenses);
 - (g) provisions/reversal of provisions (e.g. on pensions, commitments and guarantees given) except for provisions related to operational loss events;
 - (h) expenses due to share capital repayable on demand;
 - (i) impairment/reversal of impairment (e.g. on financial assets, non-financial assets, investments in subsidiaries, joint ventures and associates);
 - (j) changes in goodwill recognised in profit or loss; and
 - (k) corporate income tax (tax based on profits including current and deferred tax).