



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Capital Adequacy Framework (Basel III – Risk-Weighted Assets)

Operational Risk Exposure Draft

Applicable to:

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

This exposure draft, which is to be read together with the *Capital Adequacy Framework (Capital Components)* and the *Capital Adequacy Framework for Islamic Banks (Capital Components)*, both dated 9 December 2020, sets out the proposed requirements and guidance on the calculation of the capital charge for operational risk under Basel III by financial institutions, and is expected to come into effect in 2025. Once in effect, these requirements will supersede Part C of the *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* and the *Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets)*, both issued on 3 May 2019.

The Bank invites written feedback on the proposals in this exposure draft, including suggestions for specific issues or areas to be clarified and alternative proposals that the Bank should consider. The responses should specify the applicable paragraph, be constructive and supported with clear rationale and appropriate evidence.

In addition to providing general feedback, financial institutions are requested to:

- Respond to the specific questions set out in this exposure draft using the feedback template that has been provided within the Quantitative Impact Study (QIS) Excel workbook issued concurrently with this document; and
- Complete the QIS reporting template. Please refer to the workbook for further reporting instructions.

Both your institution's written responses and the completed QIS workbook must be submitted electronically to pfpcconsult@bnm.gov.my by **31 March 2023**.

Submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

In the course of preparing your feedback, you may direct any queries to the following officers:

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PART A OVERVIEW

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. 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.

S 1.2 The provisions on the applicability of this policy document, legal provisions pursuant to which this policy document is issued and terms and expressions used in this policy document shall be the same as those set out in the following policy documents and paragraphs:

Policy Document	Paragraph
Capital Adequacy Framework (Capital Components) issued on 9 December 2020	<ul style="list-style-type: none"> • Paragraph 2 on 'Applicability' • Paragraph 3 of 'Legal Provisions' • Paragraph 5 on 'Interpretation'
Capital Adequacy Framework for Islamic Banks (Capital Components) issued on 9 December 2020	<ul style="list-style-type: none"> • Paragraph 2 on 'Applicability' • Paragraph 3 of 'Legal Provisions' • Paragraph 5 on 'Interpretation'

S 1.3 This policy document comes into effect on [1 January 2025].

Question 1

Is the proposed implementation date feasible? If not, please provide an explanation of the potential challenges and issues your institution may face in adopting the new standards.

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://ifsb.org/download.php?id=6310&lang=English&pg=/index.php>)

PART B POLICY REQUIREMENTS

- S** 1.4 A financial institution shall calculate its total operational risk-weighted assets (RWA_{OR}) referred to in paragraph 9.2(b) of the *Capital Adequacy Framework (Capital Components)* and the *Capital Adequacy Framework for Islamic Banks (Capital Components)* as follows:

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

where –

K_{ORC} is the operational risk capital requirements as set out in paragraph 1.5.

- S** 1.5 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 1.10; and
 (b) ILM is the Internal Loss Multiplier, as set out in paragraph 1.12.

Business Indicator Component

- S** 1.6 The BIC in paragraph 1.5 shall be a function of two elements:
 (a) the Business Indicator (BI), which is set out in paragraph 1.7; and
 (b) α which is the marginal coefficient to be applied based on the value of the BI, as set out in paragraph 1.10.

- S** 1.7 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 1.8.

- S** 1.8 A financial institution shall calculate the IPC, SC and FC components as follows:

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

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

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 the most recent 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 average.

- S** 1.9 In calculating the components in paragraph 1.8, a financial institution shall comply with the additional requirements under Appendix 1⁵.

Question 2

Are the definitions as set out in Appendix 1 sufficiently clear for the purposes of calculating the BIC? If not, please provide comments and suggestions where the descriptions and examples provided can be further improved.

- S** 1.10 A financial institution shall compute the BIC referred to in paragraph 1.6 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
- (ii) *BI x α* 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>i</i>	BI range (RM billion)	BI marginal coefficients, α
1	≤1	12%
2	1 < BI ≤ 30	15%
3	> 30	18%

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)*.

⁵ Appendix 1 sets out the descriptions and examples of BI components, and the items to be excluded from the BI.

- G** 1.11 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 x 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:

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

Question 3

- (a) The BI range in the table under paragraph 1.10 had been originally prescribed by the BCBS in euros. Rather than adopt a conversion of the BI range based on a nominal exchange rate (e.g. €1:RM5), the Bank is proposing to convert the BI range to ringgit assuming a currency conversion of €1:RM1 to better reflect the relative size of banks in Malaysia. Do you agree with the proposed 1:1 conversion, and if not, why?
- (b) The Bank is also considering an option of collapsing Bucket 1 and Bucket 2 into a single category. This new category will cover a BI range of RM0 to RM30bn, with a BI marginal coefficient of 15% (consistent with the α fixed coefficient in the Basic Indicator Approach under Basel II). Are you supportive of this option, and if not, what other alternative approaches should the Bank consider to ensure that regulatory capital held for OR under Basel III remains at levels relatively consistent with that under Basel II?

Internal Loss Multiplier

- S** 1.12 Unless otherwise specified by the Bank, a financial institution shall set the Internal Loss Multiplier (ILM) as 1.
- S** 1.13 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.

Question 4

The Bank is proposing not to offer the option for financial institutions in Malaysia to adopt the ILM⁶ at this juncture with the view to achieving more comparable outcomes for the operational risk charge calculation across the industry and reducing the complexity of the framework. In this regard, the ILM = 1 shall be set for all banks, unless otherwise specified by the Bank.

Do you agree with the Bank's proposal to not offer financial institutions the option to adopt the ILM, and if not, why? Financial institutions in favour of the Bank adopting the ILM are invited to build a case for its adoption in Malaysia, and in doing so, should complete the ILM section in the appended QIS reporting template.

⁶ Please refer to Sections 5 and 6 of *Minimum capital requirements for operational risk*, pages 130-133 (<https://www.bis.org/bcbs/publ/d424.pdf>) for requirements relating to the general and specific criteria on loss data when responding to this question.

APPENDIX 1 DEFINITION OF COMPONENTS OF THE BUSINESS INDICATOR

A financial institution shall calculate components of the BI based on the descriptions provided below. Non-exhaustive lists of examples of relevant sub-items from the income statement or balance sheet are also provided for guidance.

Table 1: Interest/Profit component (IPC)

Items	Description	Examples
(a) Interest income	<p>Interest income from all financial assets and other interest income.</p> <p>This includes interest income from financial and operating leases, and profits from leased assets.</p>	<ul style="list-style-type: none"> Interest income from loans and advances, assets available for sale, assets held to maturity, trading assets, financial leases and operational leases Interest income from hedge accounting derivatives Other interest income Profits from leased assets
(b) Profit income ⁷	<p>Profit income from all financings, financial assets and other profit income.</p> <p>This includes profit income from leases/<i>ijarah</i> contracts and investment accounts.</p>	<ul style="list-style-type: none"> Profit income from all financings, assets available for sale, assets held to maturity, 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
(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

⁷ 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).

(d) Profit payable ⁸	<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>	<ul style="list-style-type: none"> Expenses or returns payable on funds received from investment account holders, current account deposits, <i>sukuk</i> issued, <i>ijarah</i>/leases contracts
(e) Interest-earning assets	This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing loans).	Total gross outstanding loans, advances, interest-bearing securities (including government bonds), leased assets
(f) Profit-earning assets ⁸	This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing financings).	Total gross outstanding financings, <i>sukuk</i> , other profit-bearing financial assets (including sovereign <i>sukuk</i>), leased assets
(g) Dividend income	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.	

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

⁸ For Islamic banking operations.

		<ul style="list-style-type: none"> • 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 stemming from operational loss events.</p> <p>This excludes expenses from operating leases.</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) • 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

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 available for sale, assets held to maturity, 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);
- (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).