This exposure draft presented by Labuan FSA is to provide an overview of the proposed requirements on capital components and risk weighted assets for Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business. It is intended to ensure that Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business maintain sufficient capital to absorb potential losses while adhering to Shariah principles.

In addition, the exposure draft incorporates further enhancements to the capital buffer requirements under the existing Banking Capital Adequacy Framework (BCAF). This exposure draft shall replace the existing requirements under BCAF and to be applicable to Labuan banks.

Labuan FSA welcomes and values feedback on the requirements of the exposure draft. The comments or inputs may encompass suggestions, recommendations and alternatives, which should be supported with clear rationale, practicality and relevance for Labuan FSA's consideration.

Feedback shall be submitted electronically to Labuan FSA using the response template by **28 February 2025** to ppu@labuanfsa.gov.my. Should you require any clarification on the exposure draft, please contact the following officers:

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To complement the ED, Labuan FSA plans to develop the prudential treatment to govern Labuan banks' exposures to digital asset in line with Basel's requirements in the near future. The industry will be consulted prior to the finalisation of the said requirements.

Mapping of the Labuan Banking and Labuan Islamic Banking Requirements

- The exposure draft of Guidelines on Capital Component (Labuan Islamic Banks) (ED), entails further enhancement to the capital buffer requirements as required under Basel III in addition to the existing CET1, Tier 1, Total Capital requirement which is currently applicable to the Labuan banks under the *Banking Capital Adequacy Framework (BCAF): Guidelines on Capital Component*. This includes capital conservation buffer and countercyclical capital buffer. The additional layer of capital buffers acts as protective cushions to ensure that Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business have extra capital during economic stress, to reflect the commitment to enhance financial resilience.
- To ensure standardisation of capital requirements and compliance with Basel III requirements across conventional and Islamic banking business, the proposed enhancement as marked in blue under the ED will also be effected under BCAF and made applicable to the Labuan banks. In this regard, **feedback from the Labuan banks is sought on the proposed capital buffer requirements as marked in blue under paragraph 8.0 and Appendix III of the ED.**

No.	Proposed Requirements under iBCAF of the ED	Existing Requirements under BCAF (Labuan Banks)	Applicability
1.	• CET1, Tier 1, Total Capital • **Capital Conservation Buffer** – *This is to ensure that banks have an additional layer of usable capital that can be drawn when losses incurred.* • **Countercyclical Capital Buffer** – *This aims to protect the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risks.* • **APPENDIX III Capital Conservation Buffer Phase-in Arrangements** – *This is to ensure that bank have an adequate transition timeline before the full implementation of the 2.5% of capital buffer.*	• CET1, Tier 1, Total Capital • Previously not required • Previously not required • Previously not required	• Labuan Islamic bank and Islamic investment banks • Labuan banks and investment banks undertaking Labuan Islamic banking business • Labuan banks and investment banks

GUIDELINES ON CAPITAL COMPONENTS (LABUAN ISLAMIC BANKS)

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1.0 Introduction

1.1 Regulatory capital requirements seek to ensure that risk exposures of a Labuan Islamic bank are backed by an adequate amount of high quality capital which absorbs losses on a going concern basis. This ensures the continuing ability of a Labuan Islamic bank to meet its obligations as they fall due while also maintaining the confidence of customers, depositors, creditors and other stakeholders in their dealings with the institution. Capital requirements also seek to further protect depositors and other senior creditors in a gone concern situation by promoting an additional cushion of assets that may be used to meet claims in liquidation.

1.2 The Labuan Islamic Banking Capital Adequacy Framework sets out the approach for computing regulatory capital adequacy ratios, as well as the levels of those ratios at which Labuan Islamic banks are required to operate. The framework has been developed based on internationally-agreed standards on capital adequacy promulgated by the Basel Committee on Banking Supervision (BCBS) and Islamic Financial Services Board (IFSB).

1.3 The *Guidelines on Capital Components (Labuan Islamic Banks)* (the Guidelines) set out the general requirements concerning regulatory capital adequacy, and the components of eligible regulatory capital. It shall be read together with the relevant Guidelines in relation to risk-weighted assets which details out the requirements for computing risk-weighted assets.

2.0 Applicability

2.1 The Guidelines are applicable to the following Labuan Financial Institutions:

(i) Labuan Islamic banks and Islamic investment banks licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and

(ii) Labuan banks and investment banks undertaking Labuan Islamic banking or Islamic investment banking business approved under Part VI of the LIFSSA.

Under the Guidelines, the term “Labuan Islamic bank(s)” refers collectively to all Labuan Islamic banking licensees as specified under paragraph 2.1.

2.1 The requirements of the Guidelines are not applicable to Labuan Islamic banks operating as branches.

2.2 With the implementation of the Guidelines, the requirements under the following Guidelines will be superseded after the effective date as provided under paragraph 4.1(ii):

(i) Guidelines on Risk-Weighted Capital Adequacy issued on 23 April 1997;
(ii) Guidelines on Risk-Weighted Capital Adequacy issued on 29 September 1997;
(iii) Guidelines on Risk-Weighted Capital Ratio (RWCR) for Subsidiary Banks issued on 10 March 2006; and
(iv) Guidelines on RWCR for Subsidiary Banks issued on 7 July 2009.

3.0 Legal Provision

3.1 The Guidelines are issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) for the purpose of clarifying the maintenance of capital adequacy ratio under Section 69 of the LIFSSA.

3.2 Any Labuan Islamic banks which fail to comply with the Guidelines may be imposed with an administrative penalty under Section 36B and Section 36G of the LFSAA and/or other enforcement actions provided under the LFSAA.

4.0 Effective Date

4.1 The Guidelines will be implemented based on the indicated timeline and would remain effective and applicable unless amended or revoked:

(i) **1 January 2026 to 31 December 2026**: one-year parallel run; and
(ii) **1 January 2027**: the effective date for full implementation of the Guidelines.

Question 1: Do you foresee any challenges with the effective date of the Guidelines with regards to the adherence to its requirements? If yes, please provide your recommendation with justification.

5.0 Level of Application

5.1 A Labuan Islamic bank is required to comply with the Islamic Banking Capital Adequacy Framework at the following levels:

(i) entity level[1], referring to the global operations of the Labuan Islamic bank (i.e. including its overseas branch operations) on a stand-alone basis; and

(ii) consolidated level, which includes entities covered under the entity level requirement, and the consolidation[2] of all financial and non-financial subsidiaries, except takaful subsidiaries which shall be deducted in the calculation of Common Equity Tier 1 Capital[3].

5.2 Where consolidation of the subsidiaries required under paragraph 5.1(ii) is not feasible[4], Labuan Islamic bank may instead, seek Labuan FSA's approval to:

(i) in the case of financial subsidiary, deduct such investments in accordance with paragraph 26.2; and

(ii) in the case of non-financial subsidiary, apply a risk weight of 1250% to such investments in accordance with paragraphs 32.0 of the *Guidelines on Risk Weighted Assets – Credit Risk.*

5.3 A summary of the general treatments referred to in paragraphs 5.1 to 5.2, as well as that applicable for other equity investments, is set out in **Appendix I**.

1 Also referred to as the "solo" or "stand-alone" level.
2 In accordance with the Malaysian Financial Reporting Standards (MFRS) and the international acceptable accounting standards as stipulated in the Directive on Financial Reporting Standards for Labuan Financial Institutions issued by Labuan FSA.
3 In accordance with paragraph 26.2.
4 For example, where non-consolidation for regulatory capital purposes is otherwise required by law.

6.0 Capital Adequacy Ratios

6.1 A Labuan Islamic bank shall calculate its Common Equity Tier 1 (CET1) Capital, Tier 1 Capital and Total Capital Ratios in the following manner:

$$\text{CET1 Capital Ratio} = \frac{\text{CET1 Capital}}{\text{Total RWA}}$$

$$\text{Tier 1 Capital Ratio} = \frac{\text{Tier 1 Capital}}{\text{Total RWA}}$$

$$\text{Total Capital Ratio} = \frac{\text{Total Capital}}{\text{Total RWA}}$$

6.2 For the purpose of paragraph 6.1:

(i) the numerators of the capital adequacy ratios are defined in accordance with the following:

(a) CET1 Capital as defined in paragraph 9.1;

(b) Tier 1 Capital shall be the sum of CET1 Capital and Additional Tier 1 Capital as defined in paragraph 10.1; and

(c) Total Capital shall be the sum of Tier 1 Capital and Tier 2 Capital as defined in paragraph 11.1;

(ii) total risk-weighted assets (RWA) shall be calculated as the sum of credit RWA, market RWA, operational RWA, and large exposure risk requirements as determined in accordance with the *Guidelines on Risk Weighted Assets (Labuan Islamic Banks)*.

(iii) where applicable, the sum of credit and market RWA in paragraph 6.2(ii) shall be further adjusted for investment accounts[5] which are recognised as a risk absorbent.

[5] For the avoidance of doubt, any committed but unfunded investment accounts (where actual cash has yet to be received from the Investment Account Holder) shall not qualify as risk absorbent.

(iv) any exposures which are deducted in the calculation of CET1 Capital, Tier 1 Capital, and Total Capital shall not be subject to any further capital charges in the computation of RWA.

7.0 Minimum Capital Adequacy Requirements

7.1 Labuan Islamic banks shall hold and maintain, at all times, the following minimum capital adequacy ratios:

CET1 Capital Ratio	Tier 1 Capital Ratio	Total Capital Ratio
4.5%	6.0%	8.0%

7.2 Notwithstanding paragraph 7.1, where Labuan FSA specifies in writing a higher minimum capital adequacy ratio for a Labuan Islamic bank after having regard to the specific risk profile of the Labuan Islamic bank, the Labuan Islamic bank shall hold and maintain such higher minimum capital adequacy ratio.

8.0 Capital Buffer Requirements

8.1 Labuan Islamic banks shall hold and maintain capital buffers, as specified by Labuan FSA, in the form of CET1 Capital above the minimum CET1 Capital, Tier 1 Capital and Total Capital adequacy levels set out in paragraph 7.1 or 7.2 respectively[6]. The capital buffers shall comprise the sum of the following:

(i) a Capital Conservation Buffer (CCB)[7] of 2.5%; and

(ii) a Countercyclical Capital Buffer (CCyB)[8], determined as the weighted average of the prevailing CCyB rates applied in the jurisdictions in which Labuan Islamic bank has credit exposures.

6 For the avoidance of doubt, a Labuan Islamic bank's CET1 Capital shall first be used to meet the minimum ratios before the remainder can count towards its capital buffers. For example, a Labuan Islamic bank with 8% CET1 Capital Ratio and which does not have any Additional Tier 1 or Tier 2 capital instruments would meet all minimum capital adequacy requirements but would not meet the capital buffer requirements.

7 The CCB is intended to encourage the build-up of capital buffers by Labuan Islamic banking during normal times that can be drawn down during stress periods.

8 The CCyB is intended to protect the Labuan banking sector as a whole from the build-up of systemic risk during an economic upswing when aggregate credit growth tends to be excessive.

8.2 For the purpose of paragraph 8.1(ii)–

(i) the CCyB to be maintained by Labuan Islamic bank shall be calculated as follows:

$$\frac{\sum_{C}(\mathrm{RWA}_{C} \times \mathrm{CCyB}_{C})}{\sum_{C}\mathrm{RWA}_{C}}$$

where–

RWA_c the sum of the following private sector credit exposures:

(a) RWA in respect of the private sector credit exposures[9] in the banking book in jurisdiction c; and

(b) RWA equivalent for trading book capital charges for specific risk, incremental risk charges (i.e. default and migration risks) and securitisation[9] in jurisdiction c;

$CCyB_c$ the prevailing CCyB rate applied in jurisdiction c;

c jurisdictions in which Labuan Islamic bank has private sector credit exposures;

(ii) in determining the jurisdiction to which a private sector credit exposure relates, Labuan Islamic banks shall use an ultimate risk basis where possible[10];

(iii) Labuan Islamic banks shall calculate the CCyB based on the prevailing CCyB rate at the date from which the rate applies, as announced by the relevant national authority;

9 This excludes exposures to sovereigns, central banks, non-federal public sector entities, multilateral development banks and banking institutions as defined in the Guidelines on Risk Weighted Assets (Labuan Islamic Banks). However, this shall include exposures to non-bank financial entities and public sector entities that are risk-weighted based on their external ratings similar to corporates.

10 For allocation of exposures to a multinational company, a Labuan Islamic bank shall, to the best of the Labuan Islamic bank's knowledge and information, determine where the risk ultimately lies and not allocate exposures solely on the basis of where the exposure is booked.

(iv) where the prevailing CCyB rate applied in a jurisdiction is more than 2.5%, the CCyB rate for that jurisdiction is capped at 2.5% for the purpose of calculating the Labuan Islamic bank's CCyB, unless specified otherwise by Labuan FSA; and

(v) if the national authority of the jurisdiction has yet to announce the CCyB rate, the rate applicable for that jurisdiction is deemed to be 0%.

PART B COMPONENTS OF CAPITAL

9.0 Common Equity Tier 1 Capital

9.1 CET1 Capital shall consist of the following:

(i) ordinary shares issued by the Labuan Islamic bank that meet the criteria specified in paragraph 12.1;

(ii) share premium resulting from the issue of ordinary shares;

(iii) retained earnings net of any interim and/or final dividend declared[11] and any interim losses. Any quarterly interim profits may be included in CET1 Capital, subject to a review/audit by the Labuan Islamic bank's external auditors[12];

(iv) other disclosed reserves[13];

(v) qualifying minority interest, as determined under paragraph 15.1; and

(vi) regulatory adjustments applied in the calculation of CET1 Capital, as determined in Part D.

10.0 Additional Tier 1 Capital

10.1 Additional Tier 1 Capital shall consist of the following:

(i) additional Tier 1 capital instruments issued by the Labuan Islamic bank that meet the criteria specified in paragraph 13.1, and are not included in CET1 Capital;

[11] In accordance with the international acceptable accounting standards as stipulated in the Directive on Financial Reporting Standards for Labuan Financial Institutions issued by Labuan FSA.

[12] Quarterly financial statements shall be reviewed in a timely manner by the Labuan Islamic bank's approved external auditors, and no qualified opinion has been made on any of the Labuan Islamic bank's quarterly financial statements in the preceding 12 months.

[13] Disclosed reserves including other accumulated comprehensive income but excluding share premium.

(ii) share premium resulting from the issue of instruments referred to in paragraph 10.1(i)[14];

(iii) qualifying CET1 and Additional Tier 1 capital instruments issued by consolidated subsidiaries of the Labuan Islamic bank and held by third parties, as determined under paragraph 15.2; and

(iv) regulatory adjustments applied in the calculation of Additional Tier 1 Capital, as determined in Part D.

11.0 Tier 2 Capital

11.1 Tier 2 Capital shall consist of the following:

(i) Tier 2 capital instruments issued by the Labuan Islamic bank that meet the criteria specified in paragraph 14.1, and are not included in Tier 1 Capital;

(ii) share premium resulting from the issue of instruments referred to in paragraph 11.1(i)[15];

(iii) qualifying CET1, Additional Tier 1 and Tier 2 capital instruments issued by consolidated subsidiaries of the Labuan Islamic bank and held by third parties, as determined under paragraph 15.3;

(iv) financing loss provisions[16] which includes collective impairment provisions and regulatory reserves, to the extent that they are not ascribed to financing classified as impaired, subject to a maximum of 1.25% of total credit RWA determined under the Standardised Approach for credit risk; and

(v) regulatory adjustments applied in the calculation of Tier 2 Capital, as determined in Part D.

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[14] Share premium that is not eligible for inclusion in CET1 Capital will only be permitted to be included in Additional Tier 1 Capital if the shares giving rise to the stock surplus are permitted to be included in Additional Tier 1 Capital.

[15] Share premium that is not eligible for inclusion in Tier 1 Capital will only be permitted to be included in Tier 2 Capital if the shares giving rise to the stock surplus are permitted to be included in Tier 2 Capital.

[16] The provisions should be gross of tax effects.

PART C CRITERIA FOR INCLUSION IN CAPITAL

12.0 Ordinary Shares

12.1 An ordinary share shall qualify as a CET1 capital instrument if it meets all the following criteria:

(i) it is directly issued and paid-up;

(ii) it represents the most subordinated claim in liquidation of the Labuan Islamic bank;

(iii) ordinary shares absorb the first and proportionately greatest share of any losses as they occur, and each ordinary share absorbs losses on a going concern basis proportionately and *pari passu* with all ordinary shares;

(iv) the paid-up amount is neither secured nor covered by a guarantee of the Labuan Islamic bank or an affiliated entity[17] or subject to any other arrangement that legally or economically enhances the seniority of the claim;

(v) principal is perpetual and never repaid outside of liquidation[18];

(vi) shareholders are entitled to a claim on the residual assets that is proportional with their respective share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim);

(vii) distributions are paid out of distributable items (including retained earnings), with the level of distributions not in any way tied or linked to the amount paid up at issuance and is not subject to a contractual cap, except to the extent that the Labuan Islamic bank is unable to pay distributions that exceed the level of distributable items;

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[17] An affiliate is defined as a company that controls, or is controlled by, or is under common control with, the Labuan Islamic bank. Control of a company is defined as (1) ownership, control, or holding with power to vote 10% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.

[18] Except for discretionary repurchases or other means of capital reduction arrangements allowable under relevant laws and regulations. Repayment of principal shall also be subject to the prior written approval of Labuan FSA.

(viii) there are no circumstances under which distributions are obligatory, and non-payment is therefore not an event of default;

(ix) distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made, thereby precluding any preferential distributions, including in respect of other ordinary shares;

(x) the paid-up amount is recognised as equity capital for determining balance sheet insolvency;

(xi) the paid-up amount is classified as equity under the international acceptable accounting standards as stipulated in the Directive on Financial Reporting Standards for Labuan Financial Institutions issued by Labuan FSA (referred to as “the acceptable FRSs”);

(xii) ordinary shares are clearly and separately disclosed on the Labuan Islamic bank’s balance sheet;

(xiii) Labuan Islamic bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory contractual terms provide any feature which might give rise to such an expectation;

(xiv) the purchase of ordinary share is not directly or indirectly funded by the Labuan Islamic bank;

(xv) the ordinary share is not purchased by the Labuan Islamic bank or its affiliated party over which it exercises control or significant influence; and

(xvi) the ordinary share is only issued with the approval of the shareholders of Labuan Islamic bank, either given directly by shareholders or, if permitted by law, given by the board of directors or by other persons duly authorised by the shareholders.

12.2 In instances where a Labuan Islamic bank issues different classes of ordinary shares with different levels of voting rights (including non-voting shares), all classes of ordinary shares must be identical in all respects except the level of voting rights in order to qualify as a CET1 capital instrument.

12.3 For the purpose of paragraph 12.1(i) where an instrument is paid-up by way of issuance of shares and not by cash (e.g. payment for take-over of another company in the form of ordinary shares), a Labuan Islamic bank is required to obtain the prior written approval of Labuan FSA to include the shares issued as regulatory capital.

13.0 Additional Tier 1 Capital Instruments

13.1 An instrument shall qualify as an Additional Tier 1 capital instrument if it meets all the following criteria:

(i) it the instrument is issued and paid-up;

(ii) the instrument is subordinated to depositors, general creditors and other holders of subordinated debt of the Labuan Islamic bank;

(iii) the instrument is neither secured nor covered by a guarantee of the Labuan Islamic bank or an affiliated entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors, general creditors and other holders of subordinated debt of the Labuan Islamic bank;

(iv) the instrument is perpetual, and shall therefore not have a maturity date, step-up features or other incentives for the Labuan Islamic bank to redeem the instrument[19];

[19] Other incentives to redeem include a call option combined with a requirement or an investor option to convert the instrument into shares if the call is not exercised, or a call option combined with a change in the reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate. For the avoidance of doubt, conversion from a fixed rate to a floating rate, or vice versa, in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem.

(v) the instrument may be callable at the initiative of the Labuan Islamic bank only after a minimum of five years, subject to the following conditions:

  (a) the exercise of a call option must receive prior written approval of Labuan FSA;
  (b) the Labuan Islamic bank must not do anything which creates an expectation that the call will be exercised; and
  (c) the call option must not be exercised unless:

    (i) the called instrument is replaced with capital of the same or better quality, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the Labuan Islamic bank[20]; or

    (ii) the Labuan Islamic bank demonstrates to the satisfaction of Labuan FSA that its capital position is and can be sustained well above the minimum capital adequacy requirements as outlined in paragraph 7.0, after the call option is exercised;

(vi) any repayment of principal[21], other than through the exercise of a call option, (e.g. through repurchase) must be with the prior written approval of Labuan FSA and the Labuan Islamic bank shall not assume or create market expectations that approval will be given;

(vii) dividends/coupons must be paid out of distributable items, and such distributions must meet the following conditions:

  (a) distributions/payments shall be at the full discretion of the Labuan Islamic bank at all times[22],[23];

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[20] Replacement issues can be concurrent with, but not after the instrument is called.

[21] Repayments due to tax or regulatory events are permitted subject to the assessment by Labuan FSA that the Labuan Islamic bank was not in a position to anticipate the event at issuance.

[22] Features such as “dividend pushers” are prohibited. An instrument with a dividend pusher obliges the issuing Labuan Islamic bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share.

[23] Any waived distributions/payments are non-cumulative i.e. are not required to, and must not, be made up by the Labuan Islamic bank at a later date.

(b) cancellation of discretionary payments must not constitute an event of default;

(c) the Labuan Islamic bank must have full access to cancelled payments to meet obligations as they fall due[24]; and

(d) cancellation of distributions/payments must not impose restrictions on the Labuan Islamic bank except in relation to distributions to ordinary shareholders;

(viii) the instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the Labuan Islamic bank or any of its affiliated entities;

(ix) the instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law governing the provisions of the instrument;

(x) the provisions governing the instrument require the instrument to be written- off, or the instrument to be converted into ordinary shares, if the consolidated or entity level CET1 Capital Ratio of the Labuan Islamic bank[25] falls below a pre-specified level, which shall be no lower than 5.125%. The aggregate amount to be written-off or converted into ordinary shares for all these instruments, on breaching the trigger level, must at least be the amount needed to immediately restore the consolidated and entity level CET1 Capital Ratio of the Labuan Islamic bank to 5.75%. If this is not possible, then the full principal value of the instrument must be written-off or converted into ordinary shares;

(xi) the instrument cannot have any features that hinder recapitalisation, such as provisions that require the Labuan Islamic bank to compensate investors if a new instrument is issued at a lower price during a specified time frame;

[24] Any structuring of bonus payment to make up for unpaid dividends is also prohibited.
[25] As disclosed in its audited financial reports/statements.

(xii) if the instrument is issued out of a special purpose vehicle (SPV), proceeds must be immediately available without limitation to the Labuan Islamic bank in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 Capital[26];

(xiii) the purchase of the instruments is not directly or indirectly funded by the Labuan Islamic bank; and

(xiv) the instrument is not purchased by the Labuan Islamic bank or its affiliated party over which it exercises control or significant influence.

14.0 Tier 2 Capital Instruments

14.1 An instrument shall qualify as a Tier 2 capital instrument if it meets all the following criteria:

(i) the instrument is issued and paid-up;

(ii) the instrument is subordinated to depositors, general creditors and other holders of subordinated debt of the Labuan Islamic bank;

(iii) the instrument is neither secured nor covered by a guarantee of the Labuan Islamic bank or an affiliated entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general creditors of the Labuan Islamic bank;

(iv) the instrument has an original maturity of at least five years, and there are no step-up features or other incentives for the Labuan Islamic bank to redeem the instrument;

(v) the instrument may be callable at the initiative of the Labuan Islamic bank only after a minimum of five years, subject to the following conditions:

(a) the exercise of a call option must receive prior written approval of Labuan FSA;

[26] For the avoidance of doubt, a capital instrument, issued out of an SPV must satisfy the requirements under paragraph 15.4 to qualify as Additional Tier 1 Capital or Tier 2 Capital (as applicable).

(b) the Labuan Islamic bank must not do anything which creates an expectation that the call will be exercised[27]; and

(c) the call option must not be exercised unless:

(i) the called instrument is replaced with capital of the same or better quality, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the Labuan Islamic bank[28]; or

(ii) the Labuan Islamic bank demonstrates that its capital position is well above the minimum capital adequacy requirements, as outlined in paragraph 7.0, after the call option is exercised;

(vi) any repayment of principal, other than through the exercise of a call option, (e.g. through repurchase) must be with the prior written approval of Labuan FSA and the Labuan Islamic bank shall not assume or create market expectations that approval will be given;

(vii) the holder of the capital instrument must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy or liquidation;

(viii) the instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the Labuan Islamic bank or any of its affiliated entities;

(ix) if the instrument is issued out of an SPV, proceeds must be immediately available without limitation to the Labuan Islamic bank in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital[26];

(x) the purchase of the instruments is not directly or indirectly funded by the Labuan Islamic bank; and

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27 An option to call the instrument after five years but prior to the start of, or during, the period in which the instrument will be gradually derecognised will not be viewed as an incentive to redeem as long as the Labuan Islamic bank does not do anything that creates an expectation that the call will be exercised at that point.

28 Replacement issues can be concurrent with, but not after the instrument is called.

(xi) the instrument is not purchased by the Labuan Islamic bank or its affiliated party over which it exercises control and significant influence.

14.2 In the final four years of its contractual maturity, a Labuan Islamic bank shall gradually derecognise the instrument from Tier 2 Capital on a straight line basis as follows:

Years to maturity (x)	Amount recognised in Tier 2 Capital
$x > 4$	100%
$3 < x \leq 4$	80%
$2 < x \leq 3$	60%
$1 < x \leq 2$	40%
$x \leq 1$	20%

15.0 Minority Interest and Capital Instruments Issued Out of Consolidated Subsidiaries and Held by Third Parties

15.1 Where the minority interest arising from the issue of ordinary shares by a fully consolidated Islamic banking subsidiary[29],[30] of the Labuan Islamic bank is recognised in consolidated CET1 Capital of the Labuan Islamic bank, the ordinary shares giving rise to the minority interest shall meet the criteria for inclusion in CET1 Capital[31].

15.2 For the purpose of paragraph 15.1, the amount of minority interest that will be recognised in consolidated CET1 Capital under paragraph 9.1(v) shall be calculated as follows:

$$\boxed{A - (B \times C)}$$

[29] An Islamic banking subsidiary in this paragraph shall mean to only include a deposit-taking entity that is subject to minimum prudential standards and level of supervision by an authority that subscribes to the Core Principles for Effective Banking Supervision promulgated by the BCBS. For the avoidance of doubt, this excludes the inclusion of any capital issued to third parties by non-banking subsidiaries, such as leasing, factoring or fund management companies.

[30] Where a fully-consolidated subsidiary of a Labuan Islamic bank has its own subsidiaries, the calculation of regulatory capital attributable to third parties shall be undertaken in respect of that subsidiary and its subsidiaries as a consolidated group.

[31] For the purpose of this paragraph, any reference to the term “Labuan Islamic bank” in paragraph 12.0 shall mean to refer to any “fully-consolidated Islamic banking subsidiary of the Labuan Islamic bank”.

where:

(a) total qualifying minority interest[32]

(b) surplus CET1 Capital of the subsidiary, calculated as CET1 Capital of the subsidiary[33] minus the lower of the following:

(i) 4.5%[34] of the subsidiary's total RWA calculated at the entity level; or

(ii) 4.5% of the portion of the Labuan Islamic bank's consolidated RWA relating to that subsidiary

(c) percentage of CET1 Capital of the subsidiary held by minority shareholders

15.3 Where Tier 1 capital instruments issued by a fully consolidated subsidiary[30,35] of the Labuan Islamic bank and held by third parties are recognised in consolidated Tier 1 Capital of the Labuan Islamic bank, the instruments shall meet the criteria for inclusion in CET1 Capital or Additional Tier 1 Capital[36,37].

15.4 For the purpose of paragraph 15.3, the amount of such capital that will be recognised in consolidated Tier 1 Capital shall be calculated as follows:

$$\boxed{A - (B \times C)}$$

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32 Including associated reserves, but prior to the application of regulatory adjustments.

33 Including associated reserves and regulatory adjustments.

34 Corresponding to the minimum CET1 capital requirement of 4.5%.

35 For the avoidance of doubt, this includes both Islamic banking and non-banking subsidiaries, but excludes takaful subsidiaries and other subsidiaries which are not consolidated for regulatory purposes.

36 For the purpose of this paragraph, any references to the term "Labuan Islamic bank" in paragraphs 12 and 13 shall mean to refer to any "fully-consolidated subsidiary of the Labuan Islamic bank" for purposes of this paragraph. For example, the early redemption of an instrument by a subsidiary shall be subject to the Labuan FSA's approval, in addition to that of the relevant host supervisor.

37 A Labuan Islamic bank may recognise Shariah-compliant capital instruments issued by subsidiaries in other jurisdictions based on the Shariah views in the respective jurisdictions, unless specifically disallowed by Labuan FSA.

where:

(a) total qualifying Tier 1 capital instruments (i.e. CET1 and Additional Tier 1) of the subsidiary issued to third parties[32]

(b) surplus Tier 1 Capital of the subsidiary, calculated as Tier 1 Capital of the subsidiary[33] minus the lower of the following:

 (i) 6.0%[38] of the subsidiary's total RWA calculated at the entity level; or

 (ii) 6.0% of the portion of the Labuan Islamic bank's consolidated RWA relating to that subsidiary

(c) percentage of Tier 1 Capital of the subsidiary held by third parties

The capital that will be recognised in consolidated Additional Tier 1 Capital under paragraph 10.1(iii) shall exclude amounts recognised in consolidated CET1 Capital as calculated under paragraph 15.2.

15.5 Where total capital instruments issued by a fully consolidated subsidiary[30,35] of the Labuan Islamic bank and held by third parties are recognised in consolidated Total Capital of the Labuan Islamic bank, the instruments shall meet the criteria for inclusion in CET1 Capital, Additional Tier 1 Capital or Tier 2 Capital[37,39].

15.6 For the purpose of paragraph 15.5, the amount of such capital that will be recognised in consolidated Total Capital shall be calculated as follows:

$$\boxed{A - (B \times C)}$$

where:

(a) total qualifying capital instruments (i.e. CET1, Additional Tier 1 and Tier 2) of the subsidiary issued to third parties[32]

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[38] Corresponding to the minimum Tier 1 capital requirement of 6%.

[39] For the purpose of this paragraph, any references to the term "Labuan Islamic bank" in paragraphs 12, 13 and 14 shall mean to refer to any "fully-consolidated subsidiary of the Labuan Islamic bank" for purposes of this paragraph.

(b) surplus Total Capital of the subsidiary, calculated as Total Capital of the subsidiary[33] minus the lower of the following:

(i) 8.0%[40] of the subsidiary's total RWA calculated at the entity level; or

(ii) 8.0% of the portion of the Labuan Islamic bank's consolidated RWA relating to that subsidiary

(c) percentage of Total Capital of the subsidiary held by third parties

The capital that will be recognised in consolidated Tier 2 Capital under paragraph 11.1(iii) shall exclude amounts recognised in consolidated CET1 Capital as calculated under paragraph 15.2 and amounts recognised in consolidated Additional Tier 1 Capital as calculated under paragraph 15.4.

15.7 Where the capital instruments issued to third parties out of an SPV are included in entity and consolidated level Additional Tier 1 Capital or Tier 2 Capital of the Labuan Islamic bank[41]:

(i) the SPV must be domiciled in Malaysia[42];

(ii) the SPV must be controlled[43] and managed by the Labuan Islamic bank, and would, in accordance with the acceptable FRSs, be fully consolidated;

(iii) the SPV must be set up for the sole purpose of the capital issuance for the Labuan Islamic bank[44] and does not conduct any other business or activity;

(iv) the SPV must not have external creditors at any time[45];

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40 Corresponding to the minimum Total Capital requirement of 8%.

41 For the avoidance of doubt, an Additional Tier 1 and Tier 2 capital instrument issued out of an SPV pursuant to this paragraph is not subject to the treatment set out under paragraphs 15.4 and 15.6.

42 Including Labuan.

43 Use of an independent SPV is allowed in structures that require the use of such SPVs, which includes the issuance of Islamic capital instruments structured using the exchange-based contracts (e.g. *Murabahah* or *Ijarah*).

44 In addition, an SPV may be established to issue tranches of one instrument where the only change in the terms and conditions of the tranches is a variation in distribution or payments to be made on the instrument. An SPV must not issue different forms of an instrument even if they belong to the same category of capital instruments.

45 Nonetheless, this does not preclude miscellaneous creditors (e.g. tax authorities, administrators) to the extent that they are de minimis.

(v) the entire proceeds from the capital issuance through the SPV[46] must be immediately available without limitation to the Labuan Islamic bank in a form which meets or exceeds all of the criteria for inclusion in Additional Tier 1 or Tier 2 Capital, as applicable; and

(vi) the provisions governing the issuance of the instruments issued by the SPV and the Labuan Islamic bank must substantially be the same (e.g. maturity), and accordingly, the capital instrument issued by the SPV must meet all the relevant criteria (as required under paragraph 13.1 for Additional Tier 1 Capital and paragraph 14.1 for Tier 2 Capital) for inclusion as if the Labuan Islamic bank itself were to issue the instrument[47],[48].

15.8 Where the capital instruments are issued to third parties through an SPV via a fully consolidated subsidiary of the Labuan Islamic bank[49] and included in the Labuan Islamic bank's consolidated Additional Tier 1 Capital or Tier 2 Capital in accordance with the treatment outlined in paragraphs 15.4 and 15.6, such capital instruments shall be subject to the requirements in paragraph 15.7, as if the subsidiary itself had issued the capital instruments directly to the third parties.

15.9 An illustration of the treatment for minority interest and capital instruments issued out of consolidated subsidiaries held by third parties is provided in **Appendix II**.

[46] This does not preclude the use of the proceeds to fund assets that relate to the operation of the SPV to the extent that they are de minimis.

[47] For example, if an SPV issues a Tier 2 capital instrument to investors and upstreams the proceeds by investing in a Tier 1 capital instrument issued by the Labuan Islamic bank, the transaction will be recognised in Tier 2 Capital.

[48] In the case of issuance of Islamic capital instruments structured using the exchange-based contracts through an SPV (e.g. *Murabahah* or *Ijarah*) or any other indirect structures (e.g. Commodity *Murabahah*), the contracts between the financial institution and the SPV or any parties involved shall be structured in a manner which in combination meets or exceeds the criteria for inclusion in capital. For example, any purchase undertaking shall be designed in a manner that does not legally or economically enhance the seniority of capital issued.

[49] The SPV must be controlled and managed by the fully consolidated subsidiary except as mentioned in footnote 43.

PART D REGULATORY ADJUSTMENTS

16.0 Goodwill and Other Intangibles

16.1 Goodwill, including bargain purchase gain[50] and any goodwill included in the valuation of significant capital investments in unconsolidated entities, and all other intangibles[51] must be deducted in the calculation of CET1 Capital. The full amount shall be deducted net of any associated deferred tax liability that would be extinguished if the intangible asset becomes impaired or is derecognised under the relevant acceptable FRSs.

16.2 Negative goodwill shall not be added back in the calculation of CET1 Capital.

17.0 Deferred Tax Assets and Liabilities

17.1 Deferred tax assets (DTAs) that rely on the future profitability of the Labuan Islamic bank to be realised shall be deducted in the calculation of CET1 Capital[52]. In this regard, a DTA may be netted against its associated deferred tax liability (DTL) only if the DTA and DTL relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. DTLs permitted to be netted against DTAs shall exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets.

17.2 Net DTLs shall not be added back in the calculation of CET1 Capital.

18.0 Property Revaluation Gains/Losses

18.1 The amount of cumulative unrealised gains arising from the changes in the fair value or revaluation of land and buildings[53] shall be treated as follows:

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50 Also known as negative goodwill.

51 As defined under the relevant the acceptable FRSs. This shall include mortgage servicing rights, if any.

52 An over installment of tax or 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. As the recovery of such a claim or receivable does not rely on the future profitability of the Labuan Islamic bank, it shall be assigned the relevant sovereign risk weighting.

53 Referring to the revaluation gains of properties that are subject to the acceptable FRSs. In addition, any recognition of revaluation gains of property in the retained earnings arising from the application of these FRSs are also subject to this treatment.

(i) cumulative unrealised gains shall be deducted in the calculation of CET1 Capital; and

(ii) 45% of the cumulative unrealised gains shall be added back in the calculation of Tier 2 Capital[54].

18.2 The amount of cumulative unrealised losses arising from the changes in fair value or revaluation of land and buildings shall be fully recognised in the calculation of CET1 Capital.

18.3 For the purpose of recognition of cumulative unrealised gains in Tier 2 Capital in accordance with paragraph 18.1(ii) the valuation of land and buildings shall be certified by an independent professional valuer at least once every three years[55] or where there is evidence that the value has been or is likely to be substantially impaired.

19.0 Cumulative Gains/Losses of Financial Instruments Classified as "available-for-sale" or "designated at fair value"

19.1 55% of cumulative unrealised gains arising from the changes in fair value of financial instruments, other than financing and receivables, classified as "available-for-sale" shall be deducted in the calculation of CET1 Capital.

19.2 For financing and receivables classified as "available-for-sale" or "designated at fair value", the amount of unrealised gains arising from the changes in fair value shall be fully deducted in the calculation of CET1 Capital.

19.3 The amount of cumulative unrealised losses arising from the changes in fair value of financial instruments, including financing and receivables, classified as "available-for-sale" shall be fully recognised in the calculation of CET1 Capital.

[54] For the avoidance of doubt, any impairment charge or accumulated amortisation/depreciation against any land and buildings is not netted against unrealised gains from any other land and buildings.

[55] For the avoidance of doubt, recognition of revaluation gains of property in the retained earnings arising from the application of acceptable of FRSs where only subject to a one-off certification by an independent professional valuer.

20.0 Cash Flow Hedge Reserve

20.1 The amount of the cash flow hedge reserve[56] that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) shall be derecognised in the calculation of CET1 Capital. In this regard, positive amounts shall be deducted and negative amounts shall be added back in the calculation of CET1 Capital.

21.0 Valuation Adjustments

21.1 The amount arising from the valuation adjustments computed in accordance with paragraphs 4.14 and 4.15 of the *Guidelines on Risk Weighted Assets (Labuan Islamic Banks)* that exceed the valuation adjustments made under the acceptable FRSs shall be deducted in the calculation of CET1 Capital.

22.0 Increase in Equity Capital Resulting from a Securitisation Transaction

22.1 Any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income resulting in a gain-on-sale, shall be deducted in the calculation of CET1 Capital.

23.0 Cumulative Gains/Losses due to Changes in Own Credit Risk on Fair Valued Liabilities

23.1 All unrealised fair value gains and losses on financial liabilities that are due to changes in the Labuan Islamic bank's own credit risk shall be derecognised in the calculation of CET1 Capital. In this regard, positive amounts shall be deducted and negative amounts shall be added back in the calculation of CET1 Capital.

23.2 In addition, all accounting valuation adjustments on derivatives liabilities that are due to changes in the Labuan Islamic bank's own credit risk shall be derecognised in the calculation of CET1 Capital. The offsetting between valuation adjustments that are due to changes in the Labuan Islamic bank's

[56] This treatment specifically identifies and removes the element of the cash flow hedge reserve that gives rise to artificial volatility in common equity, as the reserve only reflects the fair value of the derivative and not the changes in the fair value of the hedged future cash flow.

own credit risk and those arising from the counterparties' credit risk is not allowed.

24.0 Defined Benefit Pension Fund Assets and Liabilities

24.1 For each defined benefit pension fund that is an asset on the balance sheet, the asset shall be deducted in the calculation of CET1 Capital net of any associated deferred tax liability which would be extinguished if the asset becomes impaired or derecognised under the acceptable FRSs. The amount of defined benefit pension fund liabilities, as included on the balance sheet, shall be fully recognised in the calculation of CET1 Capital.

24.2 A Labuan Islamic bank shall seek a prior written approval of Labuan FSA before the assets in the fund to which the Labuan Islamic bank has unrestricted and unfettered access can be used to offset the deduction.

24.3 For the purpose of paragraph 24.2, such offsetting assets shall be risk weighted as if they were owned directly by the Labuan Islamic bank[57].

[57] This treatment 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 Labuan Islamic bank. The concern is that their only value stems from a reduction in future payments into the fund. The treatment allows for Labuan Islamic banks to reduce the deduction of the assets if they can address these concerns and show that the assets can be easily and promptly withdrawn from the fund.

25.0 Investments in Own Capital Instruments

25.1 All direct, indirect[58] and synthetic[59] holdings of a Labuan Islamic bank's own capital instruments[60] in the trading and banking book[61], including any own capital instruments which the Labuan Islamic bank is contractually obliged to purchase and any other financing[62] provided for the purpose of purchasing own capital instruments, shall be deducted in the calculation of capital. In applying the deductions, Labuan Islamic banks must deduct the investment from the same component of capital for which it would qualify[63].

25.2 In instances where a Labuan Islamic bank has an indirect exposure to its own capital instrument (e.g. through an investment in a collective investment scheme or holdings of an index security), the Labuan Islamic bank shall look through the holdings to determine their underlying holdings of capital[64].

25.3 For the purpose of paragraph 25.1, gross long positions may be netted against gross short positions in the same underlying exposure only if the short positions involve no counterparty risk[65]. In the case of an index security, where a gross long position is netted against a short position, both positions must be in the same underlying index. In such an instance, the short position may involve counterparty risk, which will be subject to the relevant counterparty credit risk

58 Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the Labuan Islamic bank substantially equivalent to the loss in value of the direct holding. An indirect holding may arise when the Labuan Islamic bank invests in an unconsolidated intermediate entity that has an exposure to the capital of the Labuan Islamic bank itself.

59 A synthetic holding may arise when a Labuan Islamic bank invests in an instrument where the value of the instrument is directly linked to the value of the capital of the Labuan Islamic bank itself.

60 Including treasury stock.

61 With the exposure amount in trading and banking book determined in accordance with the definition of exposures under the respective credit or market risk rules. For the avoidance of doubt, the exposure amount for derivatives shall refer to the delta equivalent position and not the notional value of the financial instrument.

62 Both funded and unfunded (e.g. guarantees) exposures.

63 Unless already derecognised under the relevant the acceptable FRSs.

64 If the Labuan Islamic bank finds it operationally impractical to look through the holdings of an index security, the Labuan Islamic bank may use a conservative estimate. The methodology for the estimate shall demonstrate that in no case will the actual exposure be higher than the estimated exposure, and the estimation should be updated at least annually to reflect the best estimates of the exposure. The full value shall be deducted in instances where this requirement cannot be met.

65 This includes netting positions in cash instruments and derivatives over the same underlying exposures.

charge as calculated in accordance with **Appendix VIII** of *Guidelines on Risk Weighted Assets (Labuan Islamic Banks).*

26.0 Investments in the Capital of Unconsolidated Financial and Takaful Entities

26.1 Investments in the capital instruments of unconsolidated financial61[66], and takaful entities shall:

(i) include direct, indirect[67] and synthetic[68] holdings of capital instruments. A Labuan Islamic bank shall look through indirect exposures (e.g. through an investment in a collective investment scheme or holdings of an index security) to determine its underlying holdings of capital[64];

(ii) refer to the net long positions[65] in both the banking book and trading book[61]. In this regard, the gross long position can be offset against the short position 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[69];

(iii) include underwriting positions held longer than five working days after the issuance date of the capital instruments[70]; and

(iv) with the prior written approval of Labuan FSA and subject to conditions that Labuan FSA may specify (including the period of exclusion), exclude certain investments where these have been made in the context of

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[66] These refer to investments in entities outside the scope of regulatory consolidation, namely those 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 risk-weighted assets. For the avoidance of doubt, this shall only include investments in financial and takaful subsidiaries for entity level reporting.

[67] An indirect holding may arise when a Labuan Islamic bank invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated financial or takaful entity and thus gains an exposure to the capital of that financial or takaful entity.

[68] A synthetic holding may arise when a Labuan Islamic bank invests in an instrument where the value of the instrument is directly linked to the value of the capital of an unconsolidated financial or takaful entity.

[69] Any counterparty credit risk associated with short positions used to offset long positions shall remain included in the calculation of RWA.

[70] For the avoidance of doubt, underwriting positions held for five working days or less (including pre-issuance underwriting obligations) shall be risk weighted.

resolving or providing financial assistance to reorganise a distressed institution.

26.2 The investments in the capital instruments of unconsolidated financial and takaful entities, as set forth under paragraph 26.1, shall be deducted in the calculation of capital as follows:

(i) where the Labuan Islamic banks owns more than 10% of the issued ordinary share capital of a non-affiliated issuing entity, the entire amount of investments in capital instruments;

(ii) where the issuing entity is an affiliate of the Labuan Islamic banks[17], the entire amount of investments in capital instruments; and

(iii) where the Labuan Islamic banks does not own more than 10%[71] of the issued ordinary share capital of a non-affiliated issuing entity, the amount of all capital instruments held in excess of 10% of the Labuan Islamic banks common equity[72].

In addition, Labuan FSA will also require that all reciprocal cross holdings of capital instruments that are designed to artificially inflate the capital position of a Labuan Islamic bank be deducted.

26.3 In applying the deductions under paragraph 26.2, a Labuan Islamic bank shall apply the corresponding deduction approach by deducting an investment from the same component of capital for which the capital would qualify if it was issued by the Labuan Islamic bank itself. In applying the corresponding deduction approach, if the capital instrument of the entity in which the Labuan Islamic bank has invested in does not meet the criteria for inclusion in CET1 Capital, Additional Tier 1 Capital, or Tier 2 Capital of the Labuan Islamic bank, the

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71 This includes the scenario where the Labuan Islamic bank does not owned any issued ordinary share capital of the issuing entity.

72 The common equity for purposes of calculating the 10% threshold shall be calculated after applying the regulatory adjustments set out in paragraphs 16 to 25 above to the sum of items set out in paragraphs 9.1(i) to (v).

capital is to be considered as an ordinary share for purposes of this regulatory adjustment[73] and thus deducted in the calculation of CET1 Capital.

26.4 The amount of capital holdings which is not deducted under paragraph 26.2(iii) shall continue to be risk weighted[74]. For the application of risk weighting, the amount of the holdings must be allocated on a pro-rata basis between those held below and those held above the threshold.

27.0 Other Regulatory Adjustments

27.1 In applying the regulatory adjustments against a particular tier of capital and if the Labuan Islamic banks does not have enough of that tier of capital to satisfy the deduction, any shortfall shall be deducted in the calculation of the next higher tier of capital[75].

27.2 Where Labuan FSA specifies in writing a specific regulatory adjustment in this framework in respect of a Labuan Islamic bank after having regard to the specific risk profile of the Labuan Islamic bank, the Labuan Islamic bank shall comply with such adjustment.

[73] An investment in an instrument issued by a regulated financial entity is not required to be deducted if that instrument is not deemed as its regulatory capital under the rules of the relevant authority.
[74] Instruments in the trading book shall be treated in accordance with the market risk rules and instruments in the banking book shall be treated in accordance with the credit risk rules.
[75] For example, if a Labuan Islamic bank does not have enough Additional Tier 1 Capital to meet the deductions, the shortfall will be deducted in the calculation of CET1 Capital.

PART E OTHER REQUIREMENTS

28.0 Disclosure Requirements

28.1 The full terms and conditions[76] of all Additional Tier 1 and Tier 2 capital instruments included in regulatory capital[77] shall be made available for inspection by Labuan FSA at all times.

29.0 Regulatory Process and Submission Requirements

29.1 A Labuan Islamic bank is required to obtain the Labuan FSA's written approval prior to issuance of regulatory capital by the Labuan Islamic banks, or issuance to third parties out of an SPV and included in entity and consolidated level Additional Tier 1 Capital or Tier 2 Capital. An application must be supplemented with the following:

(i) a confirmation of compliance by the Principal Officer that the proposed capital instruments comply with all the criteria for inclusion in capital as set out in paragraphs 13 and 14[78];

(ii) indicative issue and offering documents (e.g. prospectus, offering circular, pricing supplement, information memorandum, trust deed, financing agreement) and as soon as practicable, the final issue and offering documents.

29.2 For the purpose of paragraph 29.1, a Labuan Islamic bank shall seek Labuan FSA's approval for either an individual issuance or an issuance programme. Approval for an issuance programme allows subsequent issuances under the programmed to be deemed approved for recognition to the extent that the criteria for inclusion in capital continues to be met. A Labuan Islamic bank is however required to notify Labuan FSA prior to subsequent issuances under the approved programme.

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[76] Including any other relevant pricing supplements.

[77] For the avoidance of doubt, the terms and conditions of capital instruments issued by subsidiaries and held by third party investors shall also be disclosed to the extent that such capital is recognised at the consolidated level.

[78] This should include an annexe that sets out to demonstrate compliance with the applicable requirements by making references to the relevant parts of the offering documents.

29.3 A Labuan Islamic bank must seek Labuan FSA's written approval prior to any subsequent modification of the terms and conditions of an instrument that may affect its eligibility as regulatory capital.

29.4 A Labuan Islamic bank shall notify Labuan FSA of any capital instrument issued out of foreign subsidiaries to third parties that is included in consolidated CET1 Capital, Additional Tier 1 Capital or Tier 2 Capital. This shall be supplemented with, where available, a copy of the approval letter from the host supervisor confirming inclusion of the capital instrument in the foreign subsidiary's regulatory capital, and copies of the indicative or where available, final issue and offering documents. Likewise, for Labuan Islamic bank which operates as subsidiary belonging to foreign parent, it must notify Labuan FSA if it issues a capital instrument which is included in its parents' consolidated Additional Tier 1 Capital or Tier 2 Capital.

29.5 In addition to the requirements set forth under paragraphs 29.1 and 29.4, where a Labuan Islamic bank is required to provide Labuan FSA with an external legal opinion confirming that the instrument complies with all relevant criteria for inclusion in capital from a law firm of Labuan FSA's choice, the Labuan Islamic bank shall provide Labuan FSA with such legal opinion and the related expenses shall be borne by the Labuan Islamic bank.

29.6 A Labuan Islamic bank is required to obtain Labuan FSA's written approval prior to making any planned reduction in its capital[79], including capital instruments issued out of consolidated subsidiaries and held by third parties recognised under paragraphs 9.1(v), 10.1(iii) and 11.1(iii). The Labuan Islamic bank is required to demonstrate, through its capital plans that the planned reduction of capital results in capital levels remaining well above the minimum capital adequacy requirements and consistent with its risk profile and business plans.

[79] This includes a share buy-back or an early redemption, repurchase or repayment of a capital instrument, including through the exercise of a call option.

29.7 A Labuan Islamic bank should direct any regulatory application under the Guidelines to:

Director
Supervision Department
Labuan Financial Services Authority
Level 17, Main Office Tower,
Financial Park Complex
87000 Federal Territory of Labuan, Malaysia

Telephone no: 03 8873 2000
Facsimile no: 03 8873 2209
Email: *sed@labuanfsa.gov.my*

30.0 Statistical Reporting Requirements

30.1 A Labuan Islamic bank shall submit periodic reports on its capital adequacy ratios using the reporting templates provided by Labuan FSA.

Labuan Financial Services Authority
DD/MM/YY

APPENDICES

APPENDIX I General Treatment of Equity Investments

Type of Investment		Treatment	
		At the entity level	**At the consolidated level**
Islamic Banks and other financial entities excluding takaful companies	Subsidiaries	Paragraph 26	Consolidate, or deduct from CET1 Capital if allowed under paragraph 5.2
	Others	Paragraph 26	
Takaful companies	Subsidiaries	Paragraph 26	
	Others		
Other commercial entities	Subsidiaries		Consolidate, or risk-weight at 1250%[80] if allowed under paragraph 5.2
	Others	Risk-weight in accordance with *Guidelines on Risk Weighted Assets (Labuan Islamic Banks)*	

[80] In accordance with paragraph 32.0 of Guidelines on Risk Weighted Assets – Credit Risk.

APPENDIX II General Illustrative Example on Minority Interest and Capital Instruments Issued Out of Consolidated Subsidiaries Held by Third Parties

A banking group consists of two legal entities that are both Islamic banking institutions. Islamic Bank P is the parent and Islamic Bank S is the subsidiary and their unconsolidated balance sheets are set out below:

Islamic Bank P balance sheet		Islamic Bank S balance sheet	
Assets		**Assets**	
Financing to customers	100	Financing to customers	150
Investment in CET1 of Bank S	7		
Investment in the AT1 of Bank S	4		
Investment in the T2 of Bank S	2		
Liabilities and equity		**Liabilities and equity**	
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8
Additional Tier 1	7	Additional Tier 1	5
Common equity	26	Common equity	10

The balance sheet of Islamic Bank P shows that in addition to its financing to customers, it owns 70% of the ordinary shares of Islamic Bank S, 80% of the Additional Tier 1 Capital of Bank S and 25% of the Tier 2 Capital of Bank S. The ownership of the capital of Islamic Bank S is therefore as follows:

Capital issued by Bank S			
	Amount issued to parent (Bank P)	**Amount issued to third parties**	**Total**
Common Equity Tier 1 (CET1)	7	3	10
Additional Tier 1 (AT1)	4	1	5
Tier 1 (T1)	11	4	15
Tier 2 (T2)	2	6	8
Total (TC)	13	10	23

The consolidated balance sheet of the banking group is set out below:

Consolidated balance sheet	
Assets	
Financing to customers	250
Liabilities and equity	
Depositors	197
Tier 2 issued by subsidiary to third parties	6
Tier 2 issued by parent company	10
Additional Tier 1 issued by subsidiary to third parties	1
Additional Tier 1 issued by parent company	7
Common equity issued by subsidiary to third parties (i.e. minority interest)	3
Common equity issued by parent company	26

For illustrative purposes, Islamic Bank S is assumed to have risk-weighted assets of 100. In this example, the minimum capital requirements of Islamic Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any financing to Islamic Bank P. This means that it is subject to the following minimum capital requirements and has the following surplus capital:

Minimum and surplus capital of Bank S		
	Minimum capital	**Surplus**
CET1	4.5 (= 4.5% of 100)	5.5 (=10 – 4.5)
T1	6.0 (= 6.0% of 100)	9.0 (=10 + 5 – 6.0)
TC	8.0 (= 8.0% of 100)	15.0 (=10 + 5 + 8 – 8.0)

The following table illustrates how to calculate the amount of capital issued by Islamic Bank S to include in consolidated capital, following the calculation method set out in paragraph 15:

Islamic Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	**Amount issued to third parties (b)**	**Surplus (c)**	**Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (d) =(c) * (b)/(a)**	**Amount included in consolidated capital (e) = (b) – (d)**
CET1	10	3	5.5	1.65	1.35
T1	15	4	9.0	2.4	1.60
TC	23	10	15.0	6.52	3.48

The following table summarises the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between Common Equity Tier 1 and Tier 1, and Tier 2 is the difference between Total Capital and Tier 1.

	Total amount issued by parent (all of which is to be included in consolidated capital)	**Amount issued by subsidiaries to third parties to be included in consolidated capital**	**Total amount issued by parent and subsidiary to be included in consolidated capital**
CET1	**26**	**1.35**	**27.35**
AT1	7	0.17	7.17
T1	**33**	**1.60**	**34.60**
T2	10	2.30	12.30
TC	**43**	**3.48**	**46.48**

APPENDIX III Capital Conservation Buffer Phase-in Arrangements

	2027	2028	2029
Capital Conservation Buffer	0.625%	1.25%	2.5%

Question 2:

Do you foresee any challenges in implementing the above phase-in arrangements for capital conservation buffer requirement for Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business? If yes, please provide details and recommendation.

Question 3:

Do you foresee any difficulties in implementing the above capital component requirement for Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business? If yes, please provide details and recommendation.