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1. Overview

1.1. In December 2010, the Basel Committee on Banking Supervision ("Basel Committee") finalised a package of measures to strengthen global capital and liquidity rules with the goal of strengthening the resilience of the global banking system. The rules are detailed out in the documents *Basel III: A global regulatory framework for more resilient banks and banking systems* and *Basel III: International framework for liquidity risk measurement, standards and monitoring*[1] (collectively referred to as Basel III).

1.2. Bank Negara Malaysia ("the Bank") supports the implementation of these reform measures and will strengthen the existing capital and liquidity standards for banking institutions in Malaysia[2], bringing them in line with Basel III. The Bank targets to implement the reform package in Malaysia in accordance to the globally-agreed levels and implementation timeline which provides for a gradual phase-in of the standards beginning 2013 until 2019 (refer to **Appendix 1**).

1.3. This paper sets out the Bank's approach to incorporating the individual elements of the reform package into the domestic regulatory and supervisory framework, as well as its expectations of banking institutions with respect to managing the transition towards the new regime.

[1] From time to time, the Basel Committee publishes additional documents detailing out individual components of the Basel III reform package. These and other related documents are available at its website (www.bis.org/bcbs/basel3/compilation.htm). For the purpose of implementation in Malaysia, the Basel III reform package is defined to also include enhancements to the Basel II framework made by the Basel Committee in July 2009, as well as other remaining components of the Basel II framework which have yet to be implemented in Malaysia.

[2] Namely the Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks, and the Liquidity Framework.

2. Approach to implementing individual elements of the reform package

Enhancing the definition of capital

2.1. The Bank supports the aim of Basel III to strengthen the quality of capital held by banking institutions and intends to implement the new definition of regulatory capital which provides greater focus on common equity, while also strengthening the eligibility criteria for other capital instruments.

2.2. A concept paper detailing out the revised definition of regulatory capital (including the eligibility criteria for new capital instruments) will be issued for industry consultation in the first quarter of 2012, with the revised rules expected to be finalised by mid-2012 and implemented beginning January 2013 in accordance with the timelines set under Basel III (refer to **Appendix 1**).

2.3. All non-Basel III compliant capital instruments issued prior to the issuance of this circular will continue to be recognised post-2013, subject to a gradual phasing-out by 2023. Any new issuances of capital instruments by banking institutions in 2012 will only be considered by the Bank for approval if such capital instruments comply with the eligibility criteria set forth by the Basel Committee[3]. These instruments will continue to be recognised under Basel III (i.e. post-2013) even if the revised capital definition to be issued by the Bank is more stringent than the criteria set by the Basel Committee. The concept paper will provide greater detail on the approach to phasing-out non-compliant capital instruments and the phasing-in of the regulatory requirements, including that relating to the Basel II deduction rules which have yet to be implemented in Malaysia and the regulatory adjustments under Basel III.

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[3] Issuances of new capital instruments which do not contain clauses intended to ensure loss absorbency at the point of non-viability but meet all other Basel III criteria will also be considered, but may be gradually phased-out beginning 2013.

Raising the minimum capital requirements and introducing capital buffers

2.4. In addition to strengthening the quality of capital, minimum capital requirements for banking institutions in Malaysia will be raised in line with the levels determined under Basel III. Banking institutions will also be required to hold a capital conservation buffer comprising common equity of 2.5% over-and-above the regulatory minimum[4]. **Table 1** illustrates the new capital requirements, including buffers, against the Basel II standard underpinning the present Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks.

Table 1

	Common Equity Tier 1 Capital Ratio	Core Capital Ratio (CCR)[5]	Risk-Weighted Capital Ratio (RWCR)[6]
Basel III			
Minimum	4.5%	6%	8%
Conservation buffer	*+2.5%*		
Minimum plus conservation buffer	7%	8.5%	10.5%
Basel II			
Minimum	2%	4%	8%

As part of the Bank's efforts to strengthen its macroprudential toolkit to deal with systemic risk, the Bank will also consider introducing a countercyclical capital buffer regime in line with Basel III which will require banking institutions to hold variable amounts of capital buffers over-and-above the capital conservation buffer[7]. The operation and magnitude of the countercyclical

[4] Banking institutions will generally be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses, although they will be subject to restrictions on their distributions (e.g. payment of dividends). On the other hand, banking institutions will be subject to the strongest supervisory sanctions when breaching minimum regulatory levels.
[5] Also referred to as the Tier 1 Capital Ratio.
[6] Also referred to as the Total Capital Ratio.
[7] The Basel Committee provides for the size of the buffer to vary between zero and 2.5% of risk-weighted assets to be held in common equity. To illustrate, banking institutions will be required to hold up to 9.5% in common equity when the buffer is fully applied (i.e. 2.5% in common equity to be held to

buffer for exposures in Malaysia will be determined by the Bank based on its assessment of systemic risk, including indicators relating to credit growth and leverage, as informed by a methodology that will take into account domestic circumstances.

2.5. The higher capital requirements will be implemented gradually in Malaysia beginning 2013 through 2015, and the capital conservation buffer between 2016 and 2019, in line with the Basel Committee's recommended phase-in requirements as outlined in **Appendix 1**.

2.6. The Bank will issue concept papers outlining the rules and mechanisms to implement the new capital buffers by 2014. The Bank will also clarify existing supervisory processes (e.g. supervisory approvals of dividend distributions) and risk management requirements (e.g. Pillar 2 capital planning and stress testing) before the new buffer requirements are implemented.

Enhancing the risk coverage of the capital framework

2.7. Basel III also introduces measures to strengthen capital requirements for trading book and complex securitisation exposures, as well as that for counterparty credit risk exposures arising from derivatives, repo and securities financing activities. While these markets and activities have developed more noticeably in Malaysia over recent years, such activities remain less complex with risks remaining at manageable levels. At the same time, the Basel Committee is also understood to be working on more fundamental reforms to the existing market risk and securitisation frameworks. In view of this and the Bank's present assessment that current requirements sufficiently capture the nature and complexity of trading book and securitisation exposures observed in the banking system, the Bank does not expect the implementation of these enhancements to be a priority for Malaysia in the immediate term.

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meet the countercyclical capital buffer requirement, in addition to 7% to meet the minimum and capital conservation buffer requirements).

Implementation of the Leverage Ratio

2.8. Basel III introduces a Leverage Ratio which is intended to reinforce risk-based requirements and constrain the build-up of leverage, thus mitigating the effects of excessive deleveraging in the banking system during distressed periods. The Leverage Ratio also serves as an additional safeguard against model risk and measurement error inherent in the various approaches to calculating risk-weighted assets[8]. The Basel Committee has targeted that banks publicly disclose their Leverage Ratio positions beginning 2015, with the 3% target level becoming a fully binding minimum beginning 2018.

2.9. In Malaysia, leverage levels of individual banking institutions are monitored and assessed by the Bank as part of the supervisory process. A final decision to formally adopt the Leverage Ratio as a binding measure, including the need to fine tune the measurement of the Leverage Ratio, will be made by the Bank closer to the targeted 2018 deadline set under Basel III after an assessment has been made on whether the leverage ratio would work as intended and material concerns observed during the transition period have been adequately addressed. For this purpose, banking institutions will be required to report to the Bank their Leverage Ratio positions calculated according to Basel III rules beginning June 2012. Based on their current profiles, all banking institutions are expected to comfortably meet the 3% leverage level.

Additional loss-absorbency requirements for systemically important banking institutions

2.10. In addition to the main policy measures under the Basel III reform package, the Basel Committee has also proposed higher capital requirements for the largest and most internationally-active banks globally. This will require banks identified as systemically important to hold additional capital buffers ranging

[8] For example, the Internal Ratings-Based approach for credit risk and the Internal Models Approach for market risk.

from 1% to 3.5% comprising common equity, depending on a bank's systemic importance.

2.11. At present, banking institutions in Malaysia are relatively small and have less complex activities as compared to many of their international counterparts, and as such are not immediately targeted by this global measure. Nonetheless, as banking institutions in Malaysia evolve to become key regional players, it will be more important to ensure that they are better able to withstand financial shocks and contagion risk, as their significance to the domestic and regional financial system and economy increases. The Bank will therefore assess at a later date the need to require large banking institutions to operate at higher levels of capital, commensurate with their size, extent of cross-border activities and complexity of operations.

Implementation of the Liquidity Coverage Ratio and Net Stable Funding Ratio

2.12. The Bank will implement the Basel III liquidity standards in Malaysia through enhancements to the existing Liquidity Framework:

i. The Basel III Liquidity Coverage Ratio will be adopted as the standard for ensuring that banking institutions hold sufficient high quality liquid resources to survive an acute stress scenario lasting a month[9]. Accordingly, amendments to the existing measurement standard underpinning the Liquidity Framework will be made, including in regard to the list of eligible liquefiable assets and behavioural assumptions;

ii. The Bank will consider implementing the Net Stable Funding Ratio, which aims to create incentives for banking institutions to fund activities with more stable sources of funding over a one-year horizon. The new standard will act as a supplemental measure to the Liquidity Coverage Ratio under the Liquidity Framework; and

[9] The Liquidity Framework, which was issued in 1998 and first implemented in 2000, is conceptually similar with the Basel III Liquidity Coverage Ratio.

iii. Existing maturity mismatch, liquid asset and supplemental liquidity indicators reported under the Liquidity Framework[10] will also be enhanced in line with the monitoring metrics proposed under Basel III.

2.13. Prior to their formal implementation as binding measures, the Bank will commence an “observation period” to comprehensively assess the impact of the standards and consider appropriate transitioning arrangements. For the purpose of this assessment, banking institutions will be required to calculate, and report the Liquidity Coverage Ratio and Net Stable Funding Ratio to the Bank with effect from June 2012.

2.14. During the observation period, the Bank will assess the following:

- Impediments to the scope and potential for banking institutions to increase their share of retail-based funding in order to achieve compliance.
- Impact on market liquidity arising from an increase in demand by banking institutions for eligible liquid assets, particularly those which are Shariah-compliant, which in turn may alter the characteristics of these instruments and their availability to meet liquidity needs.
- Impact of the Net Stable Funding Ratio on long-term funding and the maturity transformation function performed by the banking system.
- The application of the Basel III liquidity standards on a consolidated and global basis in a manner that provides for a more comprehensive assessment of liquidity risk (i.e. including subsidiaries and foreign operations), while also giving due regard to potential impediments to the transferability of liquidity across currencies, jurisdictions and legal entities.

2.15. The Bank expects to publish concept papers laying out the proposed rules for the Liquidity Coverage Ratio in 2013 and the Net Stable Funding Ratio in 2016, in time for expected implementation from 2015 and 2018 respectively.

[10] As required under the third level of liquidity measurement in the Liquidity Framework.

3. Reporting requirements and supervisory expectations during the transition

3.1. Banking institutions will be required to calculate and report their capital, leverage and liquidity positions to the Bank based on standardised reporting templates[11] during the observation period, prior to the formal implementation of the standards as binding measures. These reporting templates will be issued to the industry in the first quarter of 2012, with reporting commencing in June 2012.

3.2. In preparation for formal implementation, the Bank expects that as part of sound capital and risk management, banking institutions should consider the likely impact of planned enhancements to the capital and liquidity requirements in setting and maintaining internal capital targets, determining funding strategies, or pursuing any transactions or strategies that could materially impact capital levels, including dividend strategies and acquisitions. Banking institutions should adopt prudent earnings retention policies with a view to meeting the enhanced capital and liquidity requirements by the expected implementation dates. The board should be adequately informed of the implications of the requirements on the banking institution's business and risk strategies, and any material challenges likely to be faced by the banking institution in meeting the requirements.

3.3. As part of its supervisory process, the Bank will engage individual banking institutions on their plans to meet the capital and liquidity requirements, particularly during:

i. annual business plan discussions;

ii. reviews of dividend proposals;

[11] This will entail banking institutions computing and reporting to the Bank their Basel III ratios prior to their formal implementation, although they will not be required to comply with the targets and minimum requirements unless otherwise notified by the Bank.

iii. supervisory assessments of banking institutions' asset-liquidity management process; and

iv. reviews of banking institutions’ capital management plans.

APPENDICES

Appendix 1 Phase-in arrangements[12]

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio		Observation period reporting						Standard in force	
Minimum common equity capital ratio[13]			3.5%	4%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.5%
Minimum common equity plus conservation buffer			3.5%	4%	4.5%	5.125%	5.75%	6.375%	7%
Minimum tier 1 capital			4.5%	5.5%	6%	6%	6%	6%	6%
Minimum tier 1 capital plus conservation buffer			4.5%	5.5%	6%	6.625%	7.25%	7.875%	8.5%
Minimum total capital			8%	8%	8%	8%	8%	8%	8%
Minimum total capital plus conservation buffer			8%	8%	8%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core tier 1 or tier 2 capital			Phased out over a 10 year horizon beginning 2013						
Liquidity Coverage Ratio		Observation period reporting			Standard in force				
Net Stable Funding Ratio		Observation period reporting						Standard in force	

[12] All dates are as of 1 January unless otherwise indicated. Shading indicates transition periods.
[13] Banking institutions will also be required to submit to the Bank calculations of their Basel III capital positions in during the observation period in 2012.