Second Consultation: Basel 3 – Draft Rulebook Module CA

Industry Comments and Feedback
May 2014

Industry Comments		
General Comments:	**Ref.**	**CBB's Response**
A bank noted that the requirements of Basel 3 are reasonable and the bank hopes once implemented will further strengthen the resilience of the banking system in the Kingdom of Bahrain. The bank would like to thank CBB for considering and incorporating the changes suggested by them and other banks.	GR-1	Noted and thanks.
A bank reiterate that Basel III's focus is on capital and funding, specifying new capital target ratios and standards for short-term and eventually, long-term funding. Although implementation of these requirements will occur over several years, the implications are immediate. While the ultimate aim is to mandate financial institutions to hold more capital and liquidity, and undertake less risk, there are concerns that there will also be unintended consequences of lower returns on capital, higher transaction costs, and slower growth potential. From a GCC perspective, these concerns are amplified at many levels, but notably on the regulation's future impact on the real economy and limited avenues to raise capital due to underdeveloped capital markets. This at a time when markets are showing signs of recovery after several years of stagnation and negative growth could severely dent the banking sectors ability to play its part in potential economic recovery of the country. Therefore, it is requested to benchmark the proposed adoption of Basel III rules with other GCC economies and ensure that Bahraini banks are not disadvantaged in any way due to possible stricter adoption of Basel III capital framework.	GR-2	It should be noted that Kuwait and Saudi Arabia have already started B3 implementation. It is not felt that the timetable or the measures are disadvantages after benchmarking.
A bank noted that, as raised in numerous previous letters on subject, the application of Basel 3 capital changes is an extremely sensitive subject as it represents an effective form of significant indirect taxation on banks by restricting their ability to grow and generate returns to their shareholders as well as on their ability to contribute to economic growth and employment. Given the far reaching implications of the proposed Basel 3 regime for the banking sector in Bahrain, it is requested that the CBB carefully assess the overall impact of their recommendations and incorporate the suggested changes into the new capital adequacy norms.	GR-3	The CBB has invited banks to participate in a quantitative impact analysis that has been ongoing since the start of 2013. This follows two previous QIAs. The revised consultation paper incorporates some material recommendations made by banks on the first consultation paper.
A bank noted that many of their previous comments on the first consultation paper have been addressed and reflected in the second consultation paper. However, there are still a small number of what they	GR-4	The CBB is consulting with other regulators on the subject

consider to be critical issues remaining in the second draft that need to be addressed. In particular, the narrative for the CVA capital charge is overly complex and difficult to understand. As noted previously, there is no longer an option for banks to adopt the IRB approach for calculating credit risk capital. It is requested that the CBB reconsiders this decision and provide Bahrain banks with the opportunity to adopt the IRB approach on meeting the required conditions so that they are not disadvantaged when compared to other regional banks that are already applying the IRB approach. In **the bank's** case, a number of Saudi Arabian banks with which **the bank** is competing for business have already adopted the IRB approach for credit risk with SAMA's approval. **The bank** is accordingly at distinct disadvantage in competing for business in the strategically key Saudi Arabian market as, under the CBB's draft Basel 3 guidelines; it is not able to adopt the more realistic and risk sensitive IRB approach for credit risk. This would also provide Bahrain banks with an important incentive to adopt and apply best industry practice in relation to risk management. In the meantime, it is suggested that the CBB arranges a round table session with banks to discuss their remaining comments to assist the CBB in understanding the critical concerns before the Basel 3 guidelines are finalized.		of the CVA. Nonetheless the concerned text is a part of Basel 3 and is applicable to both the standardised and the IRB approaches. Apart from its complexity, the IRB approach has unresolved limitations in relation to the availability of adequate default data.
A bank recommended a FAQs section on the CBB website.	GR-5	This will be considered.

Specific Comments:

Proposed rule	Comments	Ref.	CBB's Response
CA-A.2.3 **The contents retained from the previous Module (Capital Adequacy – Conventional Banks) are effective from the dates depicted above. The updated Module is effective from 1st January 2015.**	**A bank** noted that the rules do not specify the treatment that would be meted out to exposures previously grandfathered by CBB. It is presumed and it is essential that these will continue to be grandfathered post implementation of the Basel III.	A-1	Basel 3 allows transitioning of deductions and other measures on a 20% per annum basis. Banks therefore have 4 years to make adjustments before the full impact of the new rules come in. Grandfathering is not allowed to ensure consistency across jurisdictions in application of Basel 3.
CA-B.2.1	**A bank** noted that there are no transitional provisions for minimum	B-1	There are transitional

<table>
<tr>
<td rowspan="3">The transitional arrangements for implementing the new standards will help to ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital raising, while still supporting lending to the economy. The transitional arrangements are as follows:</td>
<td>total capital adequacy requirements and the implementation of the Capital Conservation Buffer – this is not the case either in Basel III or the European CRR.</td>
<td></td>
<td>arrangements for deductions and phased-out instruments. The CBB wishes to maintain the current 12% and 12.5% regime. The 2.5% capital conservation buffer replaces the ‘target’ ratio of 12.5% .</td>
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<td>A bank noted that the new ratios have been derived after incorporating a 2% step-up over the BIS-specified Basel 3 ratios (i.e., CET 1 of 6.5% vis-à-vis 4.5%; Total Tier 1 of 8% vis-à-vis 6% and Total Capital of 10% vis-à-vis 8%).
The Basel 3 Total Capital plus Capital Conservation Buffer (CCB) Pillar-I threshold of 12.5% represents a 0.5% increase over the current Pillar-I plus Pillar-II requirement of 12.0%. With additional buffers being considered (especially Countercyclical Buffer and a separate Pillar-II charge), the resultant capital requirements under the new regime may go up significantly; thus putting the banks in Bahrain at a disadvantage when compared to other international banks.
In order to enable capital planning for organic/ inorganic growth, it is requested that the CBB provide clarity on all anticipated Pillar-I buffers (vis-à-vis thresholds and implementation timelines). If additional buffers are slated to further increase capital adequacy thresholds; then it is requested to consider implementing the BIS Basel- 3 ratios directly, without the additional overlay of 2%.</td>
<td>B-2</td>
<td>The ratios directly reflect the current 12.0% and 12.5% trigger and target ratios in the rulebook.

The countercyclical buffer will only be implemented once economic conditions justify the imposition of such a buffer and subject to agreeing a methodology.</td>
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<td>A bank noted that the below table provides a comparison of Basel III minimum ratio requirements and the thresholds proposed by CBB for adoption:
<table>
<tr><th></th><th>Basel III</th><th>CBB</th></tr>
<tr><td>Components of CAR</td><td>Common Equity Tier 1 must be at least 4.5% of risk-weighted assets at all times.</td><td>6.5 %</td></tr>
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<td>B-3</td>
<td>Please see comments above (B1 & B 2).</td>
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	Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times	8%
	Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0% of risk weighted assets at all times.	10%
Capital Conservation Buffer	2.5%*	2.5%
Minimum CARs	CET1 : 7%*	9%
	Tier 1	10.5%
	Total Capital: 10.5%*	12.5%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)*	begins @ 20% on Jan 2014 towards full deduction at same % on Jan 2018	(CBB begins @ 20% on Jan 2015 towards full deduction at same % on Jan 2019)

The BIS Basel III rules require buildup of CET1 from 4.5% to 6.5% beginning from 2014 to 2018. Similarly Tier 1 capital also needs to be build up to 8% as per BIS rules, starting from minimum of 6% in 2014. In contrast, the CBB's consultation paper seems to be proposing the Banks to have CET1 and Tier 1 capital at 6.5% and 8% respectively from start of January 2015. This will be extremely challenging for the Banks and may be counterproductive for the local banking industry.

	In continuation with the above, it is understood that CBB has kept the overall CAR at 12.5% which is similar to the current requirements. However, the intrinsic change in its composition to a greater degree of CET1 and Tier1 capital poses significant challenges for the local Banks. In addition, a Capital Conservation Buffer (CCB) of 2.5% is also required to be composed of CET1 which gives as aggregate of 9% of CET1. This also results in minimum of 10.5% of Tier 1 ratio including the CCB requirement. It is suggested that regulations be amended to allow build-up of CCB reaching to a level of 2.5% till 2019. The BIS rules also require yearly build- up of CBB @ 0.625% per year for a 4 year period, reaching to 2.5%. In the meantime the Banks should be allowed to maintain their CARs at 12.5% on as is basis, gradually converting the part of capital into CET1 to be counted towards the requirement of CCB of 2.5%. **A bank** also noted that when there is not enough Additional Tier 1 (including both Tier 1 that is recognized as a result of the transitional arrangements and new qualifying Additional Tier 1) to "absorb" Additional Tier 1 deductions, are these deductions applied to Common Equity Tier 1? Also, when there is not enough Tier 2 (including both Tier 2 that is recognized as a result of the transitional arrangements and new qualifying Tier 2) to "absorb" Tier 2 deductions, are these deductions applied to Additional Tier 1?		Yes. Deductions would apply to the next Tier of capital above where there is insufficient capital of the concerned type.
CA-1.1.3 **Consolidated Total risk-weighted assets are determined by:** **(a) Multiplying the capital requirements for market risk (see CA-1.1.7) and operational risk (see CA-1.1.6) by 12.5 for the**	**A bank** noted that the RWAs for market and operational risk are calculated by multiplying the capital requirement by 12.5. This would be correct if the minimum capital requirement is 8% (i.e. 100/8 =12.5). However, if the minimum capital ratio is 12.5% the multiplier should be 8 (i.e. 100/12.5 = 8).	C-1	We have checked para 44 of Basel 2 and also checked the EU implementation of Basel3. We have also contacted the Basel Committee directly. A constant 12.5 multiplier is used irrespective of the ratios to be applied locally. There is

conventional bank licensee and all its consolidated subsidiaries; and **(b) Adding the resulting figures to the sum of risk-weighted assets for credit risk (see CA-1.1.4) and securitisation risk for the conventional bank licensee and all its consolidated subsidiaries (see CA-1.1.5).**			no guidance to allow regulators to apply a 'haircut' to this multiplier. On the contrary, both Basel and the EU allow the regulators to set higher requirements at their discretion. There are in fact six minimum capital ratios (see B3 above) varying from 6.5% to 12.5%. It would be impractical to put 6 different multipliers (from 22.2 down to 8) in place, it is clear that a consistent multiplier is also used for credit risk. The concerned multiplier will remain at 12.5. Basel Reply: While the multiplier has originally been derived as the reciprocal of the minimum total capital ratio, it is now effectively treated as a constant. In particular, this ensures that there is only one RWA number which feeds into the calculation of CET1, Tier 1 and total capital ratios, with and without the various buffers.

			This approach is also used by countries with higher national minimum requirements (already under Basel II).
CA-1.1.11 **Solo Total Capital consists of the sum of the following elements:** **(a) T1 (Going-concern):** **(i) CET1 for the parent bank only (as defined in Paragraph CA-2.1.2 but deducting item c) before applying regulatory adjustments in item d);** **(ii) AT1 for the parent bank only (as defined in Paragraph CA-2.1.4 but deducting item c) before applying regulatory adjustments in item d); and** **(b) T2 (Gone-concern) for the parent bank only as defined in Paragraph CA-2.1.8 but deducting item c) before applying regulatory adjustments in item d).**	**A bank** noted whether consideration could be given for a lower trigger issuance for solo capital purposes only. **A bank** noted that this differentiation in accounting treatment may have unintended consequences for your institutions and the cost of raising Additional Tier 1. For those jurisdictions that have retained the Basel III definitions, investors perceive differently (rightly or wrongly) the probability of default on equity accounted instruments differently to those with explicit capital triggers where the principal loss profile is clear with a corresponding impact on cost of capital. There are recent precedents in the UAE with issuance by ADIB, DIB and ENBD albeit these are "best efforts" Basel III instruments given Basel III has yet to be fully implemented in the UAE, although we would respect differing views on loss absorbency through movement in line items in equity ahead of the additional loss absorbency requirements applying.	D-1 D-2	This has been done in the second consultation. The CBB has amended the text in CA-2 to follow the Basel paper more closely with respect to equity instruments that are AT1.
CA-2.1.2A **For unrealised fair value reserves relating to financial**	**A bank** noted that CA 2.1.2A is in contrast to the current practice under Basel II where only 45% of the fair value gains/losses would be recognized. This change seems to imply that up-to 100% of the fair	E-1	100% will be recognised.

instruments to be included in CET1 Capital, <u>conventional bank licensees</u> and their auditors must only recognise such gains or losses that are prudently valued and independently verifiable (e.g. by reference to market prices). The CBB will closely review the components and extent of unrealised gains and losses and will exclude any that do not have reference to independent valuations or which are not deemed to be made on a prudent basis. As such, the prudent valuations, and the independent verification thereof, are mandatory. Unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk must be derecognised in the calculation of CET1.	value gains / losses will be recognized, a clarification on this issue would be much appreciated. Another area of concern regarding the above, which is particularly pertinent to the Bank as an investor in Private Equity investments, for which no quoted market price would be available, is what the CBB intends here by stating 'independently verifiable'? Would the Net Asset Value figures given by the Fund Manager or Discounted Cash flow calculations based valuation or internal valuations performed by the management based on the financial statements of the underlying investments qualify as 'independently verifiable' as per the Rulebook?		In this context, independently verifiable means that there is an independent source of information away from the bank that can be used so that prudent valuations may be obtained. NAVs from the fund manager may be one such source. In house sources are not independent in this context. Gains may not be recognized if they cannot be verified independently.
	A bank noted that "Independently verifiable" should also include independent valuation by one of the global four Audit firms. As not all valuations are listed or have available market prices.	E-2	Noted. See above.

CA-2.1.4 **AT1 capital consists of the sum of the items (a) to (d):** **(a) Instruments issued by the bank that meet the criteria for inclusion in AT1 outlined in Paragraph CA-2.1.6;** **(b) Stock surplus (share premium) resulting from the issue of instruments included in AT1;** **(c) Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in AT1 and are not included in CET1. See section CA-2.3 for the relevant criteria; and** **(d) Regulatory adjustments applied in the calculation of AT1 (see CA-2.4).**	**A bank** noted, on Additional Tier 1 specifically, that there is no clarification as to whether Tax or Regulatory Event calls would be permissible with the first 5 years from issuance on the instrument – in Basel III this was subsequently confirmed in a Q&A.	F-1	They are permitted.
CA-2.1.6 **For an instrument to be included in AT1, it must meet or exceed all the criteria below:** **(1) Dividends/coupons must**	**A bank** noted that no such Central Bank approval is mandated by the BCBS. Given that the AT 1 instruments are subject to strict qualifying criteria governing its terms, extent and timing of dividend payment. Furthermore, the distributions on AT 1 would be generally paid semi –	G-1	AT1 and T2 instruments would not require prior CBB approval and this will be deleted.

be paid out of distributable items (subject to CBB prior approval);	annually, the requirement to take specific CBB approval for each dividend/coupon payment is administratively cumbersome, particularly if an issuer has multiple AT1 issues with different coupon payment dates. Overall, the CBB approves dividends on CET-1 instruments. It is therefore recommended that the requirement for specific CBB approval before coupon payment is removed as long as licensee bank is above the CBB stipulated RAR threshold.		
(o) Instruments must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger event; or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified <u>trigger event</u>. The write-down will reduce the claim of the instrument in liquidation and reduce the amount that will be re-paid when a call is exercised and partially or fully reduce coupon/dividend payments on the instrument;	**A bank** noted that BCBS makes a clear distinction between equity and debt accounted AT1 instruments: - As per the 13 Jan 2011 BCBS press release, equity accounted AT1 instruments are required to have principal loss absorption, ***<u>without</u>*** the need to have Trigger Point based loss absorption linked to a CET 1 capital ratio. - As per Para 55 (11) of the BCBS final Basel 3 rules, only liability accounted AT1 instruments are required to have principal loss absorption ***<u>with</u>*** the Trigger Point based loss absorption. - BCBS defines Trigger Point at 5.125% while CBB has defined 7% CET 1 as the Trigger Point under CA-2.1.7 (D) **A bank** also noted that All GCC (KSA, Oman, Kuwait and Qatar) who have come out with Basel 3 regulations to-date have followed the BCBS approach to implement principal loss absorbency for equity accounted AT 1 i.e. no Trigger Point based loss absorbency for equity accounted AT1 instruments. Equity accounted AT-1 instruments inherently by their nature are required to absorb losses at the Point of Non- Viability, as to be determined by the CBB. It is thus recommended that CBB follows BCBS approach by • Excluding equity accounted AT1 from the application CA-2.1.7 (D); and • Reducing Trigger Point from 7% of CET1 to 5.125% of CET1 under CA-2.1.7 (D) for liability accounted AT1	H-1	This distinction between equity and liability instruments will be made clear. The trigger point must be adjusted upwards if the required CET1 minimum ratio is higher than 4.5%, otherwise the trigger point is below the minimum CET 1 ratio. This is not logical. • This can be done. • This latter request cannot be acceded to as it would place the trigger point

			below the minimum required CET1 ratio of 6.5%.
	A bank noted that under the first Basel 3 Consultation Paper issued by CBB in December 2013, **the bank's** Preference Shares were fully compliant Additional Tier 1 capital. However, the New Draft Rules issued a few weeks after the end of the first consultation period eliminate the distinction between equity and liability accounting under section CA-2.1.6 (o), thereby rendering the entire tranche of this previously fully compliant Tier 1 capital ineligible. They direct the CBB's attention to the Basel Committee paper dated June 2011 which distinguishes between equity and liability accounted instruments (please refer to clause 55 on criteria for inclusion in Additional Tier 1 capital). This reflects the nature of equity which, by definition, is loss absorbing and hence does not require an identifiable point of non-viability nor a specific trigger for this. Point-of-non-viability clauses are more relevant to subordinated debt, and seek to share the pain with bondholders in the event of a taxpayer bailout. Given the fact that (i) Bahrain is not a tax payer regime, (ii) the CBB has a stated official policy of not providing any support to wholesale banks; and (iii) Preference shares are already fully loss absorbing equity senior only to common equity, they believe that Para CA-2.17.B should be deleted and Para CA-2.1.6 (o) should be amended to be applicable only to liabilities. With respect to Additional Tier 1 and Tier 2 instruments, it is noted that the CBB has chosen a trigger level for principal loss absorption at 7%. Firstly this is higher than the Basel committee recommended level of 5.125%. Furthermore the Basel Committee paper applies such trigger only to liability accounted instrument, while CBB has extended its application to instruments classified as equity as well. This will	H-2	• Revisions will be made to follow the Basel wording more closely.

	unnecessarily put Bahrain-based banks at a competitive disadvantage when it comes to raising subordinated debt and other forms of capital in international markets and significantly increase Bahrain banks' funding costs.		

CA-2.1.8 **T2 capital consists of the sum of the following items below:** **(a) Instruments issued by the conventional bank licensee that meet the criteria for inclusion in T2 outlined in Paragraph CA-2.1.10;** **(b) Stock surplus (share premium) resulting from the issue of instruments included in T2;** **(c) Instruments issued by consolidated subsidiaries of the conventional bank licensee and held by third parties that meet the criteria for inclusion in T2 capital and are not included in T1. See CA-2.3 for the relevant criteria;** **(d) General loan loss provisions held against future, presently unidentified losses and are freely available to meet losses which subsequently materialise and qualify for inclusion**	**A bank** noted, on Tier 2, that the additional loss absorbency requirements do not apply, inconsistent with Basel III requirements. This may have a cost benefit to issuing banks albeit potentially offset by the cost of Additional Tier 1 capital as noted above.	I-1	These will be added to T2 (CA-2.1.10 and following) once amendments to AT1 have been agreed.

within T2. Such general loan-loss provisions which are eligible for inclusion in T2 will be limited to a maximum of 1.25 percentage points of credit risk-weighted risk assets. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, must be excluded; (e) Regulatory adjustments applied in the calculation of T2 (see CA-2.4); (f) Asset revaluation reserves which arise from the revaluation of fixed assets from time to time in line with the change in market values, and are reflected on the face of the balance sheet as a revaluation reserve. Similarly, gains may also arise from revaluation of Investment Properties (real estate). These			

reserves (including the net gains on investment properties) may be included in T2 capital, with the concurrence of the external auditors, provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale.			
CA-2.1.10 **For an instrument to be included in T2(see CA-2.1.8(a)), it must meet all the criteria below:** **(d) It must have a minimum maturity of at least 5 years and it will be amortised on a straight line basis in the remaining five years before maturity and there are no step-ups or other incentives to redeem;**	**A bank** noted that for subparagraph (d) it must be clarified that maturity of 5 years should be counted from the date of issuance and not from the effective implementation date of 1st January 2015.	J-1	Noted.

CA-2.2 **Limits and Minima on the Use of Different Forms of Capital**	**A bank** noted that the limitation and minima on different forms of capital i.e. a Basel II approach. They would consider one of the key benefits of the Basel III approach i.e. the maximum minimum amounts of non-CET1 instruments in solvency ratios, with no amounts excluded from total capital, is the removal of any limitation on the availability or otherwise of gone-concern loss absorbing capital, especially for jurisdictions that observe the additional loss absorbency requirements.	K-1	The proposed limits on AT1 and T2 will not apply.
CA-2.2.2 **CET1 must be the predominant form of capital. Accordingly, the contribution of AT1 instruments towards the Minimum T1 Capital Ratios mentioned in Paragraphs CA-2.2.1 and CA-2.2.1A is limited to 1.5%. Also AT1 instruments may not contribute to more than 15% of T1 Capital, once the Minimum T1 Capital Ratios mentioned in CA-2.1.1 and CA-2.2.1A have been exceeded. Any AT1 in excess of 15% of T1 will not be eligible to be included in T1 for the purpose of this Module.**	**A bank** noted that the inclusion of a cap on AT1 [maximum 15% of T1] is out of line with Basel 3 and severely limits the banks' ability to use hybrid capital. Once the CET1 minimum ratios have been met then it is much more efficient to use hybrid capital towards the total capital ratio. The cap on AT1 as prescribed will only serve to reduce the competitiveness of Bahraini banks versus our GCC peers.	L-1	See K-1 above.
	A bank noted that a ceiling on the amount of AT1 capital held by an institution at 15% of Total Tier 1 capital is illogical, and inconsistent with the intent of Basel guidelines which provide for minimum levels of capital requirements. **The bank** believes that CA 2.2.2 needs to be rephrased such that it sets minimum requirements for CET1 capital instead of putting a ceiling on AT1 capital. Specifically, relative to the minimum Tier 1 CAR (including the Capital Conservation Buffer) of 10.5% required by the New Draft Rules, CET1 capital should contribute at least 85% of this, implying a minimum CET1 CAR of 8.925%. Furthermore there is no limitation in the amount of Tier 1 capital in Basel III nor does it specify capital composition for excess capital. They are not aware of any other jurisdiction that has adopted this limitation on T1 capital as suggested by the New Draft Rules.	L-2	The 15% cap will be removed.
	A bank noted that BCBS' approach to AT 1 capital is limited to 1.5% of RWAs without any restriction on maximum AT 1 capital within	L-3	See comment L1 above.

	total Tier 1 capital CBB's approach of restricting AT 1 capital to 15% of total Tier 1 capital, if applied to Solo Tier 1 capital ratio of 6% would translate into maximum allowable AT 1 capital of 0.9% of RWAs which is less than the 1.5% limit Unlike Basel 2, Basel 3 does not specify maximum permissible AT1 or Tier 2 regulatory capital amount that can be included in the regulatory capital as Basel 3 follows RWAs driven regulatory capital structure/ thresholds. CBB is requested to apply AT 1 limit as per the BCBS approach and remove the anomaly by allowing the entire AT 1 capital to be included in the Solo and Consolidated capital ratio calculation within CBB mandated RAR components under CA-B.2.1		
	A bank noted that since the BIS paper does not place a cap on AT–1 capital, it is requested that they be excluded from the proposed guideline.	L-4	See comment L1 above.
CA-2.2.4 **The contribution of T2 capital towards the Minimum Total Capital Ratios and Minimum Total Capital plus Capital Conservation Buffer Ratios mentioned in Paragraphs CA-2.2.1 (consolidated) and CA-2.2.1A (solo) is limited to 2.0%. Also T2 instruments may not exceed 50% of CET1 Capital, once the Minimum Total Capital Ratios mentioned in CA-2.1.1 and CA-2.2.1A have**	**A bank** noted that for the same reasons stated above on CA-2.2.2, the cap on T2 capital [maximum 50% of CET1] is unnecessary and will severely restrict the use of this instrument. This is detrimental to the local banks and will allow other regional banks to have a competitive advantage over Bahraini banks. Both of these limits are throwbacks to the Basel 2 regime and they have been dropped from Basel 3. The CBB should reconsider their inclusion in the Basel 3 document.	M-1	The 50% cap will be removed.
	A bank noted that since the BIS paper does not place a cap on T–2 capital, it is requested that they be excluded from the proposed guideline.	M-2	See comment M-1 above.

been exceeded. Any T2 in excess of 50% of CET1 will not be eligible to be included in Total Capital for the purpose of this Module.			
CA-2.3.2 The amount of minority intere meeting the criteria above th will be recognised consolidated CET1 will calculated as follows: (a) Total minority interest meeting the two criteria in Paragraph CA-2.3.1 minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders; (b) Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of: (i) The minimum CET1 requirement of the subsidiary plus the capital conservation buffer (CCB) (i.e. 7.0% of risk weighted assets) and; (ii) The portion of the consolidated minimum	**A bank** noted that BCBS' approach is the same as CBB. However the BCBS minimum CET1 requirement is set at 7% (including Capital Conservation Buffer) as compared to the higher minimum 9% CET 1 mandated by the CBB. Therefore, it is recommended to amend the rules from 7% RWAs to 9% RWAs commensurate with the higher CBB mandated minimum CET1 capital requirement	N-1	The consolidated minimum CET1 requirement in point (ii) will be amended to 9% RWAs.

CET1 requirement plus the CCB (i.e. 7.0% of consolidated risk weighted assets) that relates to the subsidiary; and **(c) The amount of the surplus CET1 that is attributable to the minority shareholders is calculated by multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.**			
CA-2.4.16 **The regulatory adjustment described in Paragraph CA-2.4.17 applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the <u>conventional bank licensee</u> does not own more than 10% of the issued common share capital of the entity. In addition:** **(a) Investments include direct, indirect[1] and**	**A bank** has the following queries on this rule: • Clarification is required on the definition of "Capital". Does capital includes investment in the non-voting shares of the investee companies / funds? Furthermore, if the investment of the bank is in private equity funds who have treated the Bank's investment as a liability instead of the Fund's capital, will this still be considered as an investment in the capital of the fund? • Clarification on the definition of financial entities is required. Will unregulated private equity funds fit under the definition of financial entities? • Clarification is required on the term "Outside the regulatory consolidation". CA-2.4.20 (footnote 6), states the investments outside regulatory consolidation means those investments which have not been consolidated? In this perspective, a holding below 10% will mostly be outside the regulatory consolidation (unless the	O-1	• Clarifications are already given in CA-2.4.16(a) and (b). 'Capital' in this context means all financial instruments recognized as regulatory capital by the concerned regulator and similar instruments issued by financial entities. This would include non-voting stock of funds. • A financial entity is defined in module PCD-1.1.2 as "an entity which

[1] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

synthetic holdings of capital instruments. For example, <u>conventional bank licensees</u> must look through holdings of index securities to determine their underlying holdings of capital;[2] (b) Holdings in both the banking book and trading book must be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long	bank controls the company through a management agreement).		conducts banking activities or other financial activities such as finance leasing, issuing credit cards, portfolio management, investment advisory, money changers, factoring, forfaiting, custodial and safekeeping services and other similar activities that are ancillary to the business of banking, whether or not the entity is regulated". • Yes such funds are included in the above definition. • This means such entities are not included in the consolidation. Sections CA-B.1 and CA-2.2 describe regulatory consolidation.

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

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

deducted.			
CA-2.4.16 **The regulatory adjustment described in Paragraph CA-2.4.17 applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the conventional bank licensee does not own more than 10% of the issued common share capital of the entity. In addition:** **(a) Investments include direct, indirect[3] and synthetic holdings of capital instruments. For example, conventional bank licensees must look through holdings of index securities to determine their underlying holdings of capital;[4]** **(b) Holdings in both the**	**A bank** noted that for this rule and CA 2.4.17 need to be reviewed as this would basically make investment banking model redundant. The most common business for all investments banks is to seek attractive equity investments for future returns. If this rule is enforced, it would basically mean that well diversified banks would not be able to make equity investments beyond 10% of their CET1a. This would basically make investment banking business unsustainable.	P-1	This is a minimum Basel 3 requirement.

[3] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in value of the direct holding.

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

banking book and trading book must be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year); (c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included; and (d) If the capital instrument of the entity in which the conventional bank licensee has invested does not meet the criteria for CET1, AT1,			

or T2 (see CA-2.1.2(f)) of the concerned bank, the capital is to be considered common shares for the purposes of this regulatory adjustment. However, if the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant jurisdiction of the financial entity, it is not required to be deducted.			
CA-2.4.17 **If the total of all holdings listed in Paragraph CA-2.4.16 in aggregate exceed 10% of the <u>conventional bank licensee's</u> CET1a (i.e. after applying all other regulatory adjustments from Paragraph CA-2.4.2 to Paragraph CA-2.4.15) then the amount above 10% is required to be deducted, applying a corresponding deduction approach. This means the deduction should be applied to the same component of capital for which the capital**	**A bank** noted that investments in the capital of banking, financial and insurance entities, outside the scope of regulatory consolidation and the bank does not own more than 10% of the issued common share capital. Clarification with some examples will be appreciated.	Q-1	CBB will include new examples in Module PCD.

would qualify if it was issued by the conventional bank licensee itself. Accordingly, the amount to be deducted from CET1a must be calculated as the total of all holdings which in aggregate exceed 10% of the conventional bank licensee's CET1a (as per above) multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a CET1a deduction which corresponds to the proportion of Total Capital holdings held in CET1a. Similarly, the amount to be deducted from AT1 must be calculated as the total of all holdings which in aggregate exceed 10% of the conventional bank licensee's CET1a (as per above) multiplied by the AT1 holdings as a percentage of the Total Capital holdings. The amount to be deducted from T2 must be calculated as the total of all holdings which in aggregate exceed 10% of the conventional			

bank licensee's CET1a (as per above) multiplied by the T2 holdings as a percentage of the Total Capital holdings.			
CA-2.4.20 **The regulatory adjustment described in CA-2.4.21 applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where the conventional bank licensee owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate of the conventional bank licensee. In addition:** **(c) Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included;**	**A bank** suggested for subparagraph (c) that the 5 days holding period for underwriting commitments be extended to 90 days to bring it in line with the requirements of CM module and for practicality purposes.	R-1	The 5 day period is stipulated by Basel (for capital adequacy purposes).
	A bank noted that as per CA-2.4.20 significant investments include entities which are an *affiliate* of the bank. In their letter to the CBB dated April 8, 2014 they had already expressed their concern regarding the definition of connected counterparties and of affiliates under Basel III rules not being in line with the current accounting rules. It is recommended that the definition of affiliates should be documented in the Rulebook to be in line with the definition in IFRS 10. This will ensure that there is no ambiguity between the standards set by the CBB and the IASB. At the same time it will ensure that the rule continues to capture exposures where the bank is the investor and has control or significant influence over such an investment as a principal rather than as an agent. The use of percentage ownership as the criteria to determine whether an investment is a significant investment is a material departure from the prevailing Rulebook definition for a "large exposure" which is based on the size of the investment relative to the total capital base of the bank. Consequently, the New Draft Rules will miss very large exposures if they represent less than a 10% common shareholding in the underlying entity, which seems illogical. Similarly, the New Draft Rules will deem relatively small-sized investments as being significant, just because they happen to be more than 10% of the underlying entity.	R-2	This is a matter for alignment of CM. The qualifying holdings section will need to be rewritten to align with the new rules. We disagree that the new draft rules miss exposures which are less than 10% of the concerned entity's capital. These are covered in CA-2.4.16 to 19.
CA-2.4.25 **The following items receive**	**A bank** noted that currently as per Basel II the excess over 15% of the capital is deducted equally from Tier 1 and Tier 2 and the remaining	S-1	The rule will be amended. For any exposure (e.g. significant

a 1250% risk weight: **(a) Certain securitisation exposures outlined in Chapter CA-6;** **(b) Non-payment/delivery on non-DvP and non-PvP transactions (see Appendix CA-4); and** **(c) Significant investments in commercial entities above the materiality thresholds. The materiality threshold for these investments are: 15% of Total Regulatory Capital for individual significant investments; and 60% of Total Regulatory Capital for the aggregate of such investments. Please refer to Paragraph CA-2.4.20 for the thresholds for individual 'significant' investments for the purpose of this paragraph (i.e. a holding of 10% or more of the equity in a commercial entity).**	exposure is risk weighted. Clarification is required on the methodology to be used for risk weighting under Basel III as the criteria covers only specific instances.		investment in commercial entities, credit / loans and advances exposures) exceeding the 15% large exposure limit, the excess amount will be, risk weighted at 800%. However the other types of exposures mentioned in points (a) and (b) will remain risk weighted at 1250%.
	A bank noted the current rules (CM-5.5.1 and PCD 2.4.2) requires large exposures consisting of both loans and equity investments in excess of 15% of the Bank's capital base to be deducted from regulatory capital. Hence, their understanding is that with the introduction of CBB's Basel 3 rules, for a large exposure above 15% of the regulatory capital, any equity holdings in excess of 10% or more in a commercial entity needs to be risk weighted at 1250%. The remaining part of the excess large exposure, which may include loans and other equity investments, above the 15% threshold will be deducted from capital. Could the CBB confirm that the bank's understanding is correct? Secondly, if it is correct, the CM and PCD sections of the CBB's current rulebook will need to be amended to make it clear that excess large exposures , consisting of equity holdings of 10% or more in a commercial entity, will not be required to be deducted from capital but instead risk weighted at 1250%.	S-2	See comment S-1 above. Amendment to CM and PCD will be necessary.
	A bank noted that in the CBB circular EDBS/KH/0191/2010 titled "Basel 3 Quantitative Impact Analysis" point 7 states: "Total Eligible capital Deductions previously made for significant investments in	S-3	See comment S1 above.

	commercial entities shall now be risk weighted at 1250%. *Any large exposures to non-financial entities above the 15% capital limit must be risk weighted at 1250%.* Assume no grandfathering of concessions." In the consultation under CA 2.4.25, reference is made to a 15% materiality threshold for investments in commercial entities. However the rules are silent here on whether other large exposures (e.g. credit / loans and advances exposures) exceeding 15% would also be weighted at 1250%, whereas the text of the 2010 letter seems to indicate that this would be the case. Are there any deductions to be made from CET1 or other tiers for excesses over the large exposure limit? Clarification on this issue would be greatly appreciated.		
	A bank noted that under current guidelines contained in the CBB's Rulebook [refer PCD-2.3.2], it is clear that only the excess in the size of an investment, above the threshold for it being deemed a "large exposure", qualifies for a punitive capital charge in the form of a 1-for-1 deduction from capital of the excess amount of exposure (see illustration below). By contrast, the New Draft Rules [para CA-2.4.25 and CA-3.2.26] are ambiguous whether it is the excess exposure above the threshold for a significant investment or the total exposure that qualifies for a punitive capital charge. While the CBB had mentioned in its response to questions on the First Basel 3 Consultation Paper that a punitive capital charge is only applicable on the excess exposure above the threshold limit under section CA-2.4.25, the same clarification was not made with respect to CA-3.2.26. Furthermore this clarification does not appear to have been included in the New Draft Rules. It is requested that the CBB does so under both the above referred sections. Furthermore, CA-2.4.25 and CA-3.2.26, both relate to treatment of significant investments in corporate entities. As per CA-2.4.25 the threshold for significant investments is defined with reference to Total	S-4	The Basel Committee has released a new paper on Large Exposures which covers these issues. See comment S-1 above.

	Regulatory Capital, while as per CA-3.2.26 the same threshold is defined with reference to Common Equity Tier 1 Capital (CET1). As these two sections relate to the same items, they should have the same basis of calculations. In thier opinion the definition utilized in CA-2.4.25 is more appropriate as it replaces the treatment for significant investments under Basel II as well as the CBB's prevailing Rulebook. Hence, CA-3.2.26 should be amended to be in line with CA-2.4.25 and the term Total Regulatory Capital should be clearly defined in the Rulebook. Finally, the New Draft Rules stipulate a risk weighting of 1,250% for significant exposures, which under a 12.5% capital requirement would require a capital charge in excess of the amount for which the asset is carried on the balance sheet, which is completely illogical.		See comment S-1 above.
CA-2A.2.1 **<u>Conventional bank licensees</u> are required to hold a Capital Conservation Buffer (CCB) of 2.5%, comprised of CET1 above the regulatory minimum Total Capital ratio of 10%.[5] Capital distribution constraints will be imposed on a <u>conventional bank licensee</u> when the CCB falls below 2.5%. The constraints imposed only relate to distributions, not the operation of the <u>conventional bank licensee</u>.**	**A bank** noted that this section has undergone significant change in this consultation. Both within the BIS document and first consultation paper, the 2.5% buffer was divided into quartiles and restriction on dividend distribution varied (ranging from 0% - 100% of earnings) depending on the buffer level being maintained. However, with the removal of the quartiles and the related limits on conservation as stipulated in the BIS paper, the proposed module aims to make Capital Conservation Buffer a hard threshold (no dividend distribution being possible when operating within this range); thus making it more onerous on banks, particularly with the introduction of additional buffers planned. Hence if CBB plans the introduction of additional buffers in due course, it is requested that the rulebook be aligned with the BIS document to address the above issue; especially since Capital conservation buffer and countercyclical buffer (under consideration separately by CBB) follow the same approach as per BIS.	T-1	At present the CBB reviews dividend proposals. This revision is consistent with current CBB practice.

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

Appendix CA-2	Comments	Ref.	CBB's Response
Internal Models	**A bank** noted that this section allows banks to calculate exposure at default for counterparty credit risk by using either the standardized method or the current exposure method. The internal models method (IMM) for calculating counterparty credit risk exposure, which is permitted by the Basel committee, is not allowed as per the CBB's draft rulebook. However, there are instances in the appendix where the IMM is referred to. This inconsistency has not been addressed in the second draft of the rulebook. For example, paragraph 53 of appendix CA-2 refers to "IMM capital charge" and there are several definitions in Section I of the appendix which relate only to the IMM method.	U-1	The internal models method allows banks to model the capital charge for general market risk. What the CBB is doing is saying that modelling of counterparty risk (as per IRB) is not permitted. In the absence of reliable historical data, the CBB will not permit the use of the FIRB approach to credit risk or counterparty credit risk.
CVA Capital Charge	**A bank** noted that, in their opinion, the narrative is overly complex and difficult to understand. It is recommended that this is rewritten so that it is more comprehensible. This is of particular importance as it is a completely new requirement and calculation. Additionally, as the use of IMM for calculating specific market risk or counterparty credit risk is not allowed as per the draft rulebook, their understanding is that the CBB's intention is to allow banks to only use the standardized approach for calculating the CVA capital charge. Paragraph 51 of the draft rulebook appears to suggest that the CVA capital charge can be computed by more than one method. Additionally, paragraph 52 includes several references to the IMM approach, which need to be removed.	V-1	See comment GR-4 above. The narrative comes from Basel 3.