CAPITAL ADEQUACY FRAMEWORK

FOR FINANCE COMPANIES

Date: 14 July 2022

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PART A: OVERVIEW

A1: INTRODUCTION

1. Capital is important to a finance company[1] as, apart from being a permanent source of funding for business operations and growth, it provides a buffer to absorb losses from impaired credit facilities. In so doing, capital not only reduces the risk of insolvency of a finance company but can also enable the finance company to continue to conduct its financing businesses / Islamic financing businesses in times of stress, thereby reducing any propensity for the finance company sector to amplify the effects of a financial and economic downturn. The prudential regulation of finance companies therefore seeks to ensure that finance companies hold sufficient capital (and reserves) against the inherent risks in their business.

A2: POLICY OBJECTIVE

2. The Capital Adequacy Framework sets out the approach for computing regulatory capital adequacy ratios, which has been developed based on internationally-agreed standards on capital adequacy promulgated by the Basel Committee on Banking Supervision (BCBS). Given their limited scope of activities and as deposit taking institutions, a simplified version of the Capital Adequacy Framework is made applicable to finance companies in Brunei Darussalam. Appendix 1 summarizes the options exercised by BDCB in areas where national discretion is provided by the BCBS to the national supervisory authority.

A3: GLOSSARY

BDCB	:	means Brunei Darussalam Central Bank;
BCBS	:	means the Basel Committee on Banking Supervision;
CRM or credit risk mitigation	:	means any technique used by a finance company to reduce the credit risk associated with any exposure which the finance company holds;
financing business	:	shall have the same meaning as defined under the Finance Companies Act, Cap. 89;
finance company	:	refers to all finance companies licensed under the Finance Companies Act, Chapter 89;

[1] As defined in Section A3: Glossary

finance company group	:	means the Finance Company and its finance company group entities;
finance company group entity	:	means any subsidiary or any other entity treated as part of the Finance Company's group of entities according to Accounting Standards;
insurance/takaful subsidiaries	:	means a subsidiary which carries on insurance or takaful business as an insurer / takaful provider
Islamic financing business	:	Shall have the same meaning as defined under the Finance Companies Act, Cap. 89;
RWA	:	means risk-weighted assets;

PART B: APPLICATION

B1: APPLICABILITY

3. A finance company shall comply with the Capital Adequacy Ratio (CAR) requirements in this framework at two levels:

   3.1. **standalone ("Solo") level** CAR requirements, which measure the capital adequacy of a finance company based on its standalone capital strength and risk profile; and

   3.2. the consolidated **("Group") level** CAR requirements, which measure the capital adequacy of a finance company based on its capital strength and risk profile after consolidating the assets and liabilities of its finance company group entities as specified by BDCB.

B2: SCOPE OF CONSOLIDATION

4. When preparing the consolidated financial statements of the finance company group for the purpose of calculating its capital adequacy ratio requirements at the Group level, the following shall apply: -

   4.1. The assets and liabilities of the financial entities engaged in the following activities listed below shall be consolidated on a line-by-line basis. Non-financial subsidiaries shall be consolidated using the equity method. Unless agreed with BDCB, the scope of consolidation shall include majority-owned or controlled financial entities that engage in the following financial activities: -

      4.1.1. Finance leasing and operating leasing;

      4.1.2. issuing credit cards;

      4.1.3. portfolio management;

      4.1.4. investment advisory;

      4.1.5. custodial and safekeeping services; and

      4.1.6. other similar activities that are ancillary to the financing business / Islamic financing business.

   4.2. Any investment in an insurance/takaful subsidiary shall be excluded from consolidation;

4.3. Minority interests by third parties in the share capital of subsidiaries which are less than wholly-owned by the parent finance company will not be recognized unless the amount of such minority interests can be shown by the finance company to be readily available to support other group entities or the parent finance company itself. This means such minority interests should not be added into the capital of the consolidated finance company group unless the concerned minority shareholders have explicitly stated in writing that their holdings are available to support the finance company.

5. In the event that any majority-owned other financial subsidiaries are not consolidated for capital adequacy purposes, all equity and other regulatory capital investments in those entities attributable to the finance company group will be deducted, and the assets and liabilities, as well as third-party capital investments in the subsidiary will be removed from the parent finance company's balance sheet. This deduction approach shall also be used for all investments in any subsidiaries at the 'solo' level (see also paragraph 14 onwards).

6. The BDCB will ensure that the entity that is not consolidated and for which the capital investment is deducted meets any applicable regulatory capital requirements.

7. The BDCB will monitor actions taken by the concerned subsidiary to correct any capital shortfall and, if it is not corrected in a timely manner, the shortfall will also be deducted from the parent finance company's capital.

PART C: CAPITAL ADEQUACY RATIO (CAR)

C1: CAR COMPUTATION

8. A finance company shall compute the respective ratios in accordance with the following formula: -

$$\text{Tier 1 CAR} : \frac{\text{Tier 1 Capital}}{\text{RWAs (Credit + Operational)}}$$

$$\text{Total CAR} : \frac{\text{Total Capital}}{\text{RWAs (Credit + Operational)}}$$

9. The amount of RWAs would be derived from different categories of assets weighted according to broad categories of relevant riskiness.

10. The RWAs consist of the following:

    10.1. Credit RWAs, which aim to measure the amount of credit risk associated with a particular types of asset depending on the obligor;

    10.2. Operational RWAs, which aim to measure the amount of operational risk resulting from inadequate or failed internal processes, people and systems or from external events.

PART D: COMPONENTS OF CAPITAL

D1: TOTAL CAPITAL

11. In determining its Total Capital, the finance company shall add the components of qualifying Tier 1 Capital and Tier 2 Capital respectively, after taking the necessary capital adjustments and deductions.

    11.1. In applying the regulatory adjustments against a particular tier of capital and if the finance company does not have enough of that tier of capital to satisfy the deduction, any shortfall shall be deducted in the calculation of the next highest tier of capital.

    11.2. Where BDCB specifies in writing a specific regulatory adjustment in this framework in respect of a finance company after having regard to the specific risk profile of the finance company, the finance company shall comply with such adjustment.

<u>Tier 1 Capital</u>

12. Tier 1 Capital is a finance company's primary source of strength. Tier 1 Capital, which is intended to absorb losses on a going concern basis, consists of the following: -

    12.1. Paid up Ordinary Shares

    12.2. Non-cumulative, Non-redeemable Preference Shares

    12.3. Share Premium resulting from the issuance of ordinary shares

    12.4. Statutory Reserve Funds

    12.5. Retained Earnings net of any interim and/or final dividend declared and any interim losses. Any quarterly interim profits may be included in Tier 1 Capital, subject to a review/audit by the finance company's external auditors[2]

    12.6. General reserves[3]

    12.7. Fair Value Reserves arising from fair valuing financial instruments

    12.8. Prudential Reserve for Credit Losses[4]

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

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

[4] As defined under Regulatory Notice on Prudential Treatment of Problem Assets and Accounting for Expected Credit Losses, and as may be revised from time to time.

Tier 2 Capital

13. Tier 2 Capital is intended as a complement to Tier 1 Capital. Tier 2 Capital is subject to certain limits outlined in paragraph 14 below. Tier 2 Capital is intended to absorb losses on a gone concern basis, and consists of the following:

13.1. General Credit Loss Reserves created against the possibility of potential losses.

13.1.1. These reserves pertain to the Allowance for Credit Losses on Stage 1 financial assets and loan commitments accounted using IFRS 9.

13.1.2. General Credit Loss Reserves eligible for inclusion in Tier 2 are capped at 1.25% of the sum of credit risk-weighted assets.

13.1.3. Finance companies are free to take higher levels of Allowance for Credit Losses on Stage 1 but these will not be included in Tier 2 capital.

13.2. Capital instruments which combine certain characteristics of equity capital and debt that satisfy the following characteristics:

13.2.1. Prior written approval of BDCB has been obtained for inclusion of such items in the capital.

13.2.2. Unsecured, fully paid up and subordinated to the interests of creditors.

13.2.3. Not redeemable in less than 5 years or without the prior approval of authority.

13.2.4. Available to participate in losses without the finance company being obliged to cease trading.

13.2.5. Obligation to pay interest/profit can be deferred where the profitability of the finance company would not support such payment.

13.2.6. Any other condition stipulated by BDCB on prudential grounds.

13.3. Subordinated term debt that satisfies the following conditions: -

13.3.1. The prior written approval of BDCB has been obtained for inclusion as Tier 2 capital.

13.3.2. Unsecured and subordinated to the interests of creditors, at fully paid up value in the case of coupon bonds or paid up value plus accrued interest/profit in the case of zero coupon bonds.

13.3.3. A minimum original maturity of 5 years.

13.3.4. Early repayment or redemption shall not be made without the prior consent of BDCB. The instrument may not contain any features such as 'step-up' features which have the effect of triggering early repayment prior to original maturity.

13.3.5. The amount counted as capital shall be discounted by a cumulative discount factor of 20% at the beginning of each year during the five years preceding maturity (i.e. discounted to zero during final 12 months prior to maturity).

Years to Maturity (x)	Amortised amount eligible to be included in Tier 2 Capital
$4 < x \leq 5$	80%
$3 < x \leq 4$	60%
$2 < x \leq 3$	40%
$1 < x \leq 2$	20%
$x \leq 1$	0%

D2: ADJUSTMENTS AND DEDUCTIONS

14. A finance company shall apply the following regulatory adjustments and deductions in the calculation of Tier 1 and Tier 2 Capitals at the Solo or Consolidation level, as the case may be:

14.1. Reciprocal crossholdings of capital artificially designed to inflate the capital position of finance companies will be deducted for capital adequacy purposes from the concerned tier of capital at which the investment is made.

14.2. Goodwill relating to investments in consolidated subsidiaries and other entities subject to a deduction approach (see below) pursuant to this part should be deducted from Tier 1.

14.3. Significant minority investments by the finance company in other financial entities, where control does not exist, will be deducted from the finance company group's capital by deduction of the equity and other regulatory investments.

14.3.1. The threshold above which minority investments will be deemed significant and be thus deducted is defined as equity interests of between 20% and 50% in the concerned financial entity (Refer to Appendix 2].

14.3.2. For solo reporting, finance companies must additionally deduct their equity investments in financial subsidiaries from total capital. Finance companies must also ensure that all assets and liabilities of such financial subsidiary companies are not included in solo reporting.

14.4. A finance company shall deduct any equity and other regulatory capital investments in insurance/takaful subsidiaries and also significant minority investments by the finance company in insurance/takaful entities.

14.4.1. Under this approach, the finance company must remove from its balance sheet assets and liabilities, as well as third party (minority interest) capital investments in an insurance/takaful subsidiary.

14.5. Significant minority and majority investments by a finance company in commercial entities which exceed certain materiality levels will be deducted from finance companies' Total Capital.

14.5.1. Materiality levels (or deduction thresholds) of 15% of the finance companies' capital for individual significant investments in commercial entities and 60% of the finance companies' capital for the aggregate of such investments will be applied. An example of the effect of the two deduction thresholds is shown in Appendix 3 to this framework.

14.5.2. The amount(s) to be deducted will be that portion of the investment(s) that exceed(s) the concerned materiality level(s).

14.5.3. The ownership threshold above which minority investments will be deemed 'significant' and trigger the above materiality thresholds for deduction is defined as any equity interests of 20% or above in the equity of the concerned commercial entity.

14.5.4. Deduction of investments pursuant to this part will be 50% from Tier 1 and 50% from Tier 2 capital.

14.6. Tier 2 Capital may not exceed Tier 1 Capital. Furthermore, subordinated term debt may not exceed 50% of Tier 1 Capital. The limits on Tier 2 capital instruments will be based on the amount of Tier 1 capital after deduction of goodwill but before the deductions of investments pursuant to scope of application. Please also note the limit on General Credit Loss Reserves in paragraph 13.1.2.

14.7. Minority interests arising as a result of any holding by a third party in any of the consolidated subsidiaries of the finance company are not eligible for inclusion in Total Capital.

14.8. Any advances or financing facilities offered by the finance company to its employees for the purchase of the finance company's shares under an employee ownership plan must be deducted from the finance company's regulatory capital.

14.9. Any unamortised dealers' commission paid by the finance company to the car dealers must be deducted from the finance company's regulatory capital.

PART E: CREDIT RISK

E1: INTRODUCTION

15. The Credit RWAs must be measured by classifying on-balance sheet assets and assigning risk weights to each class of assets according to the relevant riskiness.

16. A finance company shall determine its capital requirements for credit risk using the Standardised Approach. This framework further allows a finance company: -

    16.1. to use External Credit Assessments (or external ratings) on the borrower as the basis for determining the appropriate risk weights;

    16.2. to apply Credit Risk Mitigation (CRM) techniques to obtain capital relief in the form of credit protection through cash collateral; and

    16.3. to apply a risk weight of 75% to its retail portfolio segment, subject to meeting the necessary criteria; and

17. Whilst the Standardised Approach specifies the applicable risk weight for a particular exposure, BDCB reserves the right to exercise its discretion to apply a different risk weight to particular counterparties or asset classes from that specified under this framework in certain circumstances such as in situations where there is enough evidence to suggest that loss experience in a particular asset class had increased or the overall asset quality of certain institutions have been deteriorating.

E2: EXTERNAL CREDIT ASSESSMENTS

18. External credit assessments (or external ratings) on the counterparty (borrower) are the basis for the determination of risk weights under the Standardised Approach for exposures to sovereigns, central banks, public sector entities, banks, corporates as well as certain other specific portfolios.

19. In accordance with the rules and principles laid down by the BCBS, the BDCB has identified the following international rating agencies as External Credit Assessment Institutions (ECAIs) for the purposes of risk weighting exposures for capital adequacy purposes:

    19.1. Moody's

    19.2. Standard and Poor's; and

    19.3. Fitch Ratings

20. Finance companies are required to obtain the prior approval of the BDCB before using other ECAIs.

21. Finance companies should use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Finance companies will not be allowed to "cherry pick" the assessments provided by different ECAIs.

22. Finance companies shall not use one ECAI's rating for one exposure, while using another ECAI's rating for another exposure to the same counterpart, unless the respective exposures are rated by only one of the chosen ECAIs whose ratings the finance company has decided to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group (e.g. where such other entities are not rated).

23. For finance companies registered and incorporated abroad, the rating applicable to the Head Office may be used as the rating applicable to the particular branch, if the branch is not rated locally.

24. Finance companies shall be guided by the following in respect of exposures/ obligors having multiple ratings from the eligible ECAIs chosen by the finance company for the purpose of risk weight computation: -

    24.1. If there is only one rating by an eligible ECAI for a particular claim, that rating shall be used to determine the risk weight of the claim.

    24.2. If there are two ratings accorded by an eligible ECAI, which map into different risk weights, the higher risk weight shall be applied.

    24.3. If there are three or more ratings accorded by eligible ECAI with different risk weights, the ratings corresponding to the two lowest risk weights shall be referred to and the higher of those two risk weights shall be applied, i.e., the second lowest risk weight.

    24.4. Other unassessed claims of an issuer will be treated as unrated.

E3: TYPES OF EXPOSURES AND RISK WEIGHTS

25. The various categories of exposures and their corresponding risk weights are applicable to all **on-balance sheet exposures,** which shall be multiplied by the appropriate risk weight to determine the RWA amount.

26. For purposes of capital adequacy computation, exposures shall be reported using the applicable International Financial Reporting Standard (IFRS). For credit exposures

accounted for using IFRS 9, the carrying value includes accrued interests/profits, net of Stage 2 and 3 Allowance for Credit Losses.

27. In the case of a lease where the finance company is exposed to residual value risk (i.e. potential loss due to the fair value of lease instalments being below the estimate of the residual value of the lease asset reflected on the balance sheet of the finance company at lease inception), the finance company shall calculate (i) an exposure to the lessee equivalent to the discounted lease payment stream; plus (ii) an exposure to the residual value of the leased asset equivalent to the estimate of the residual value reflected in the balance sheet of the finance company.

Exposures to Sovereigns and Central Banks

28. Claims on and placements with the Government of Brunei Darussalam and the BDCB, denominated and funded in Brunei Dollar (BND) shall be accorded a preferential risk weight of 0%.

29. Any exposures in BND where there is an explicit guarantee provided by the Government of Brunei Darussalam or the BDCB, shall also be accorded a preferential risk weight of 0%, provided the guarantee satisfies the conditions in section E4.

Exposures to Public Sector Entities (PSEs)

30. Exposures on domestic PSEs shall be risk-weighted at 0% if all of the following criteria are met: -

    30.1. the PSE has been established under its own statutory act;

    30.2. the PSE and its subsidiaries are not involved in any commercial undertakings;

    30.3. a declaration of bankruptcy against the PSE is not possible; and

    30.4. the PSE is fully funded by Government of Brunei Darussalam and any lending facilities obtained by the PSE are subjected to strict internal lending rules by the PSE.

31. The definition of Domestic PSEs includes an administrative or regulatory body or non-commercial undertaking responsible to, or owned by the Government of Brunei Darussalam.

Exposures to Banks

32. On-balance sheet claims on and placements with banks shall be risk weighted according to the external credit assessment of the bank entity as provided in Table 3.

Table 3: Risk Weights for Banks				
Rating Category	Standard and Poor's Rating Services (S&P)	Moody's Investors Service (Moody's)	Fitch Ratings (Fitch)	Risk Weight
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%
2	A+ to A-	A1 to A3	A+ to A-	50%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	50%
4	BB+ to B-	Ba1 to B3	BB+ to B-	100%
5	CCC+ to D	Caa1 to C	CCC+ to D	150%
Unrated				50%

Exposures to Other Deposit-taking Institutions and Securities Firms

33. Claims on and placements with Securities Firms and Other Deposit-taking Institutions such as finance companies and Perbadanan TAIB may be treated as claims on banks provided these firms are subject to supervision by the BDCB.

33.1. In such cases, such exposures shall be risk weighted according to the external credit risk assessment as shown in Table 3 above.

Exposures to Corporates

34. Exposures on rated Corporates, including claims on insurance/takaful companies shall be risk weighted according to the external credit assessment of the entity as provided in Table 4.

35. The risk weight for unrated claims on Corporates incorporated in Brunei Darussalam, shall be 100%.

Table 4: Risk Weights for Corporates (including Insurance/Takaful Companies)				
Rating Category	Standard and Poor's Rating Services (S&P)	Moody's Investors Service (Moody's)	Fitch Ratings (Fitch)	Risk Weight
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%
2	A+ to A-	A1 to A3	A+ to A-	50%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	100%

5	B+ to D	B1 to C	B+ to D	150%
Unrated				100%

The Regulatory Retail Portfolio

36. Subject to meeting the required criteria, exposures included in the Regulatory Retail Portfolio (excluding Non-Performing Regulatory Retail exposures) may be risk-weighted at 75%.

37. To be included in the Regulatory Retail Portfolio, the following criteria must be met: -

37.1. **Orientation criterion** – The exposure is to an individual person or persons or to a small business, which may be sole-proprietorships, partnerships or small and medium-sized enterprises (SMEs). In this case, the small business must be located in Brunei Darussalam and it must not be a subsidiary or associate of another company;

37.2. **Product criterion** – The exposure takes the form of any of the following: term loans/financing and leases (e.g. instalment loans/financing, auto loans/financing and leases).

37.3. **Granularity criterion** -– The portfolio[5] must be sufficiently diversified to a degree that reduces the risks in the portfolio warranting the 75% risk weight.

37.4. **Low value of individual exposures** - The maximum aggregated retail exposure to any one counterpart cannot exceed an absolute threshold of BND 750,000.

38. Where an exposure or counterparty does not fulfill the criteria above, the exposure shall be risk-weighted at 100%.

Non-Performing Exposures

39. This part specifies the treatment for Non-Performing Exposures[6]. Subject to paragraph 40, the **unsecured portion** of any Non-Performing Exposure, net of Allowance for Credit Losses, shall be risk-weighted as follows: -

Condition	Risk Weight
Where provisions are no less than 20% of the outstanding principal amount of the exposure	100%
Where provisions are less than 20% of the outstanding principal amount of the exposure	150%

[5] A factor to be considered is whether the aggregate exposure to one counterpart is not more than 0.2% of the overall Regulatory Retail Portfolio. The 0.2% limit does not apply where the Regulatory Retail Portfolio has less than 1,000 customers.

[6] As defined in paragraph 4 in Notice No. BU/N-8/2018/58 – Prudential Treatment of Problem Assets and Accounting for Expected Credit Losses (as may be amended from time to time).

40. For the purposes of paragraph 39 above, a bank shall calculate the unsecured portion of a Non-Performing Exposure, as follows: -

Unsecured Portion = A – P – C

Where:-

(i) A = the outstanding Non-Performing Exposure;

(ii) P = Allowance for Credit Losses provided for the exposure; and

(iii) C = fair value of eligible financial collateral[7] received;

Non-Performing retail loans/financing must be excluded from the overall Regulatory Retail Portfolio for risk-weighting purposes.

Other Assets

41. Cash and gold[8] will be risk-weighted at 0%.

42. The standard risk weight for all other assets will be 100%.

Investments which are below Threshold for Deductions

43. Investments for this category include investments in the capital instruments of banks, financial institutions, and commercial entities (including insurance/takaful companies).

44. Any investments which are not eligible for deduction from the finance company's capital shall be risk weighted based on the external credit rating as provided in Table 5.

Table 5: Risk Weights for Investments below Deduction Threshold

Rating Category	Standard and Poor's Rating Services (S&P)	Moody's Investors Service [Moody's]	Fitch Ratings (Fitch)	Risk Weight
1	AAA to AA-	Aaa to Aa3	AAA to AA-	100%
2	A+ to A-	A1 to A3	A+ to A-	100%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%
4	BB+ to BB-	Ba1 to B3	BB+ to BB-	100%
5	B+ to D	B1 to C	B+ to D	150%

[7] Eligible collateral will be the same as for credit risk mitigation purposes (see Section E4)

[8] Refers to holding of gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities. Cash items in the process of collection can be risk weighted at 20%

Unrated		150%

E4: CREDIT RISK MITIGATION (CRM)

45. Finance companies are allowed to use cash collateral to mitigate the credit risks to which they are exposed. The following outlines the general requirements for the use of cash collateral.

46. The CRM is only applicable to on-balance sheet exposures.

47. No additional CRM will be recognised for capital adequacy purposes on exposures where the risk weight is mapped from a rating specific to a debt security where that rating already reflects CRM. For example, if the rating has already taken into account a guarantee pledged by the parent of the borrower, then the guarantee shall not be considered again for CRM purposes.

48. While the use of CRM techniques reduces or transfers credit risk, it may introduce or increase other risks such as legal, operational and/or market risk. Therefore, it is imperative that finance companies control these risks by employing robust policies, procedures and processes including strategies to manage these risks, valuation, systems, monitoring and internal controls. Finance companies must be able to demonstrate to the BDCB that they have adequate risk management policies and procedures in place to control these risks arising from the use of CRM techniques.

    48.1. In any case, BDCB reserves the right to take supervisory action under Pillar 2[9] should the finance company's risk management in relation to the application of CRM techniques be insufficient.

    48.2. In addition, finance companies will also be expected to observe Pillar 3 requirements[10] in order to obtain capital relief in respect of any CRM techniques.

<u>Minimum Conditions for the Recognition of CRM</u>

49. In order for finance companies to obtain capital relief, CRM arrangements must satisfy the eight general conditions for legal certainty below for the finance company and its customers. Finance companies must have conducted a review with a sufficiently well-founded legal basis to verify compliance with these conditions and undertake such further review as necessary to ensure continuing compliance.

    49.1. Documented (All CRM tools must be documented and not be verbal or implied).

    49.2. Explicit (The CRM provider has taken on an explicit obligation and the purpose is clearly explained so that the cash deposit is not used for other purposes and the arrangement cannot be terminated without mutual written agreement).

[9] Pillar 2 refers to the Supervisory Review Process of the Basel II Framework
[10] Pillar 3 refers to the Disclosure Requirements under the Basel II Framework

49.3. Enforceable (All CRM tools must be binding both parties where the cash deposit is placed. Arrangements must not be 'ultra vires']

49.4. Direct (The arrangement is not via a third party. Cash is placed directly with the finance company).

49.5. Specific (the arrangement must refer to specific exposures or a group of exposures so that the extent of cover is clearly defined and incontrovertible. This is particularly important where a facility is partly collateralized or there are multiple cash deposits.

49.6. Unconditional (There must be no restrictive covenants. The CRM covers all types of payments that the customer is expected to make under the transaction).

49.7. Irrevocable (The deposit must be pledged for at least the life of the exposure. The CRM arrangement cannot be unilaterally cancelled without the consent of the finance company).

49.8. Timely (Upon default or non-payment of the counterparty, the finance company may pursue the collateral provider promptly and the release of the deposit is made in a timely manner. In this context, 'prompt' would generally mean within 7 days of the due date and 'timely' would generally mean within 90 days of non-payment).

<u>CRM Techniques - Collateralised Transactions</u>

50. A collateralised transaction is one in which: -

50.1. finance companies have a credit exposure or potential credit exposure; and

50.2. that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty.

51. For collateralised transactions, finance companies shall apply the simple approach which, consistent with the Basel I framework, substitutes the risk weight of the collateral for the risk weight of the counterparty for the collateralised portion of the exposure.

52. Under this approach, where an exposure on a counterparty is secured against eligible collateral, the secured portion of the exposure must be weighted according to the risk weight appropriate to the collateral. The unsecured portion of the exposure must be weighted according to the risk weight applicable to the original counterparty.

53. The collateral must be pledged for at least the life of the exposure and marked-to-market and re-valued at a minimum frequency of 6 months.

54. The risk weight on the collateralised portion will be subject to a floor of 20% except under the conditions specified in paragraph 56.

55. The 20% floor for the risk weight on a collateralized transaction will not be applied and a 0% risk weight can be applied where any of the following applies: -

55.1. The exposure is collateralized by cash in the same currency placed on deposit with the concerned finance company; or

55.2. The exposure is denominated in BND and is collateralized by SGD deposits placed with the concerned finance company.

<u>Eligible Collateral</u>

56. The risk weighting of certain exposures may be substituted by that of certain eligible collateral, subject to the floor of 20%. In the computation of capital adequacy requirements for collateralised transactions, the only collateral instruments eligible for recognition under the simple approach subject to the minimum conditions specified in paragraph 50 above being met is cash (including certificate of deposits issued by the finance company) on deposit with the finance company which is incurring the counterparty exposure. Risk weight is 20% (unless in same currency as exposure – see paragraph 56 above).

PART F: OPERATIONAL RISK

F1: INTRODUCTION

57. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

58. A finance company shall have in place internal operational risk management framework that commensurate with the nature, complexity and sophistication of their business activities.

    58.1. A finance company **should adopt the practices set out in the report "Principles for the Sound Management of Operational Risk" issued by the BCBS in Ju**ne 2011.

F2: THE BASIC INDICATOR APPROACH (BIA)

59. In this regard, finance companies shall hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted α) of positive annual gross income[11].

60. The charge for operational risk may be expressed as follows:

$$\boldsymbol{K_{BIA}} = [\sum \boldsymbol{GI_{1 \ldots n}} \times \boldsymbol{\alpha}]/\boldsymbol{n}$$

where:

K_{BIA} = the capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

n = number of the previous three years for which gross income is positive

α = 15%

[11] If the annual gross income for any given year is negative or zero, the figure shall not be included for the purposes of calculating the operational risk capital charge.

61. A finance company shall calculate its gross income[12] as the sum of its net interest/profit income[13] and non-interest/profit income[14], taking into account the following:-

61.1. be gross of any provisions (e.g. for unpaid interest/profit);

61.2. be gross of operating expenses, including fees paid to outsourcing service providers15;

61.3. exclude extraordinary or irregular items; and

61.4. exclude any income derived from any insurance/takaful recoveries.

[12] Audited gross income figures shall be used where available. Where audited figures are not available, unaudited gross income figures may be used, provided that the reporting finance company shall reconcile, on a timely basis, such unaudited gross income figures with its audited financial statements (as well as any quarterly and half-yearly financial statement which has been reviewed by external auditors, where available), and use the latest reconciled numbers for future calculations.

[13]Net interest/profit income is defined as interest/profit income less interest/profit expense.

[14] Non-interest/profit income includes fees and commissions income after deducting fees and commissions expense.

[15] In contrast to fees paid for outsourced services, any fee received by any reporting finance company for its outsourcing services shall be included in the definition of gross income.

Appendix 1: National Discretion

Application in Basel II document (June 2006 version	Summary of National discretion	BDCB Treatment
PART B: SCOPE OF APPLICATION		
28	Threshold for minority investments in banking and financial entities to be deemed significant and be either deducted or consolidated on a pro-rata basis.	The threshold level for pro-rata consolidation is ownership equal to or above 20% but less than 50%. Deduction where these criteria are not met.
30-34	Treatment of significant investments in insurance/takaful subsidiaries	Deduct any equity and other regulatory capital investments in insurance/takaful subsidiaries and also significant minority investments by the bank in insurance/takaful entities.
PART E: CREDIT RISK		
54	Lower risk weight to claims on sovereign (or Central Bank) in domestic currency, if funded in that currency	Apply 0% risk weight for exposures to Government of Brunei Darussalam and BDCB.
55	Recognition of Export Credit Agencies assessment.	Not recognized.
57	Claims on domestic PSEs	Domestic PSEs accorded 0% if criteria specified under paragraph 30 met. Otherwise, treated as corporates.
58	Claims on domestic PSEs as if sovereigns (Treatment if other regulators adopt preferential treatment)	Exercised for Brunei PSEs.
60-64	Claims on banks Option 1: risk weight one category less than sovereign. Option 2: risk-weight on the bank's external credit assessment	Option 2 applied.
65	Allow securities firm to be treated as banks.	Allowed provided firms are subject to supervisory and regulatory arrangements comparable to the Basel 2 or 3 Framework (including, in particular, risk-based capital requirements). Otherwise, treated as Corporates.

67	Increase standard risk weight for unrated claims when a higher risk weight is warranted by the default experience in their jurisdiction.	Unrated corporates accorded with 100% risk-weight.
68	To risk weight all corporate claims at 100% without regard to external ratings.	Not exercised.
69	Definition of claims included in Regulatory Retail Portfolio.	Definition provided under paragraphs 36-38.
70	Granularity criterion for the retail portfolio, limit of 0.2% of the overall retail portfolio.	0.2% threshold applied. The 0.2% limit not applicable where the Regulatory Retail Portfolio has less than 1,000 customers.
71	To increase risk-weights for regulatory retail portfolio exposures.	Risk-weight maintained at 75%.
75 & 78	Risk-weight for the unsecured portion of a loan/financing past due, net of specific provisions, reduced to 50% when specific provisions are more than 50%.	Not exercised.
75 Footnote 30	Past due treatment for non-past due loans/financing to counterparties subject to a 150% risk-weight.	Not exercised.
76 Footnote 31	Transitional period of 3 years for recognition of a wider range of collateral for higher risk categories (past due assets).	Not exercised.
77	If a past due loan/financing is fully secured by other forms of collateral, a 100% risk weight may apply when provisions reach 15% of the outstanding amount.	Not exercised.
81 Footnote 32	Risk weight gold bullion at 0%.	Exercised.
90-91	Acceptable Credit Rating Agencies	Banks may choose from the following: - 1. Moody's 2. Standard & Poor's 3. Fitch IBCA Others are subject to prior approval of BDCB.
92	Mapping of ECAI assessments to Risk Weights.	Exercised.
108	Use of unsolicited ratings	Not exercised.
PART F: OPERATIONAL RISK		
650	Definition of Gross Income.	Definition provided under paragraph 61.

652 Footnote 104	Allow banks to use the alternative standardized approach.	Not exercised.
654 Footnote 105	Treatment of negative gross income.	Negative numbers should be excluded.
663 Footnote 108	As some internationally active banks will wish to use the Standardised Approach, it is important that such banks have adequate operational risk management systems. Consequently, an internationally active bank using the Standardised Approach must meet the criteria in paragraph 663. For other banks, these criteria are recommended, with national discretion to impose them as requirements.	All finance companies are expected have in place internal operational risk management framework that commensurate with the nature, complexity and sophistication of their business activities. A finance company should adopt the practices set out in the report "Principles for the Sound Management of Operational Risk" issued by the BCBS in June 2011.

Appendix 2: Example of Significant Investments in Banks, Securities Firms and Other Financial Entities

This appendix explains how 'significant' minority investments in the regulatory capital of other financial entities cause deductions to a finance company's capital.

Let us assume that Finance Company A has $100mn of capital after deduction of goodwill and other items in worksheet CAR-2 at cell C16 of the Capital Adequacy Return.

Finance Company A has the following investments, only some of which are 'significant' because the finance company owns 20% or more, but less than 50% of the issued share capital of the concerned financial entity.

Financial Entity	% of Capital Financial Entity	Status
Bank B	100%	Subsidiary
Insurance Company C	25%	Significant Investment
Securities Firm D	40%	Significant Investment
Finance Company E	15%	Investment

Having established the treatment of the Financial Entities, the regulatory treatment can then be decided upon as shown below.

Financial Entity	% of Capital Financial Entity	Status	Regulatory Treatment
Bank B	100%	Subsidiary	Full consolidation of assets and liabilities
Insurance Company C	25%	Significant Investment	Deduction of full amount of value of investment
Securities Firm D	40%	Significant Investment	Deduction of full amount of value of investment
Finance Company E	15%	Investment	Risk weighting of investment at 100% (listed) or 150% (unlisted), subject to accounting treatment and determination of 'control' of finance company

In the case of Finance Company E, the auditor must make a determination whether Finance Company A exercises 'control' over Finance Company E by means other than voting control over shares held by Finance Company A. Control may be exercised by means of the holding of proxy votes, or board or management appointments. The BDCB will follow accounting treatment of investments where control is determined to exist. In cases of 'control', then the amount of investment will be deducted from the capital of Finance Company A.

Appendix 3: Example for Significant Investments in Commercial Entities

This appendix explains how the materiality thresholds of 15% (M1) and 60% (M2) of a finance company's Total Capital cause deductions to a finance company's Total Capital where a finance company makes 'significant investments' in another entity's share capital.

Let us assume that Finance Company A has $100mn capital after deductions of goodwill and other deduction items in worksheet CAR-2 at cell C16 of the Capital Adequacy Return.

Finance Company A has the following commercial investments, all of which are 'significant' because the Finance Company owns 20% or more of the issued share capital of the concerned entity.

Materiality threshold 1 (M1) is $15mn. This means that the portion of any investment in a commercial entity which exceeds M1 shall be deducted as shown below.

Investee	Amount of Investment	M1 Deduction
B	$11mn	N/A
C	$12mn	N/A
D	$16mn	$1mn
E	$20mn	$5mn
F	$40mn	$25mn
Aggregate	**$99mn**	**$31mn**

This means that a deduction of $31mn of Capital will be applied in respect of M1 deductions. We now need to check if there will be any deductions in respect of the aggregate of such investments. First we need to calculate the remaining residual amounts of significant investments after M1 deductions to check if they exceed the M2 limit of $60mn (60% of total capital).

Investee	Amount of Investment	M1 Deduction	Residual Amount After M1 Deduction
B	$11mn	N/A	$11mn
C	$12mn	N/A	$12mn
D	$16mn	$1mn	$15mn
E	$20mn	$5mn	$15mn
F	$40mn	$25mn	$15mn
Aggregate	**$99mn**	**$31mn**	**$68mn**

As can be seen, the residual amount of investments after M1 deductions is $68mn. This is $8mn in excess of the M2 limit and therefore a second M2 deduction to total capital will be applied. This brings the total deductions to capital in respect of significant investments in commercial entities to $39mn [i.e. $31mn (M1) + $8mn (M2)].

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