

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

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

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

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

- i) Nurhamizah Basaran (nurhamizah@labuanfsa.gov.my) (03-8873-2110)
- ii) Carmelitta Liaw (carmelitta@labuanfsa.gov.my) (03-8873-2036)
- iii) Jennifer Voon Mei Ying (jennifer@labuanfsa.gov.my) (03-8873-2034)

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

GUIDELINES ON RISK WEIGHTED ASSETS – OPERATIONAL RISK

TABLE OF CONTENTS

1.0	Introduction	1
2.0	Applicability	1
3.0	Legal Provision	2
4.0	Effective Date.....	2
PART A	POLICY REQUIREMENTS.....	3
5.0	Total Operational Risk-Weighted Assets	3
6.0	Business Indicator Component	3
7.0	Internal Loss Multiplier (ILM).....	6
Appendix I	Definition of Components of the Business Indicator	7

1.0 Introduction

- 1.1 The *Guidelines on Risk Weighted Assets – Operational Risk* (the Guidelines) set out the standards and guidance for the calculation of a financial institution's operational risk-weighted assets under the Banking Capital Adequacy Framework and Islamic Banking Capital Adequacy Framework. These requirements are broadly in line with the Basel III standards set by the Basel Committee on Banking Supervision (BCBS)¹ and the capital standards issued by the Islamic Financial Services Board (IFSB)², and have been modified accordingly where applicable.

2.0 Applicability

- 2.1 The Guidelines are applicable to the following Labuan Financial Institutions:
- (i) Labuan banks and investment banks licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);
 - (ii) Labuan Islamic banks and Islamic investment banks licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and
 - (iii) Labuan banks and investment banks undertaking Labuan Islamic banking or Islamic investment banking business approved under Part VI of the LIFSSA.

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

- 2.2 The requirements of the Guidelines are not applicable to Labuan banks operating as branches.
- 2.3 Upon the full implementation of the Guidelines as specified under paragraph 4.1(ii), the requirements under Part C of the *Banking Capital Adequacy Framework*

¹ Basel III: Finalising Post-Crisis Reforms, December 2017 (<https://www.bis.org/bcbs/publ/d424.pdf>)

² IFSB 23: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (https://www.ifsb.org/wp-content/uploads/2023/10/IFSB-23_En.pdf)

- *Guidelines on Risk Weighted Assets* issued on 30 December 2016 are superseded.

3.0 Legal Provision

- 3.1 The Guidelines are issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) for the purpose of clarifying the maintenance of capital adequacy ratio under Section 94 of the LFSSA and Section 69 of the LIFSSA.
- 3.2 Any Labuan banks which fail to comply with the Guidelines may be imposed with an administrative penalty under Section 36B and Section 36G of the LFSAA and/or other enforcement actions provided under the LFSAA.

4.0 Effective Date

- 4.1 The Guidelines will be implemented based on the indicated timeline and would remain effective and applicable unless amended or revoked:
- (i) **1 January 2026 to 31 December 2026**: one-year parallel run; and
 - (ii) **1 January 2027**: the effective date for full implementation of the Guidelines.

PART A POLICY REQUIREMENTS

5.0 Total Operational Risk-Weighted Assets

- 5.1 Labuan bank shall calculate its total operational risk-weighted assets (RWA_{OR}) as follows:

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

where –

K_{ORC} is the operational risk capital requirements as set out in paragraph 5.2.

- 5.2 Labuan bank shall calculate its operational risk capital requirements (K_{ORC}) as follows:

$$K_{ORC} = BIC \times ILM$$

where –

- (i) BIC is the Business Indicator Component, as set out in paragraph 6.7; and
- (ii) ILM is the Internal Loss Multiplier, as set out in paragraph 7.0.

6.0 Business Indicator Component

- 6.1 The BIC in paragraph 5.2 shall be a function of two elements:

- (i) the Business Indicator (BI), which is set out in paragraph 6.2; and
- (ii) α which is the marginal coefficient to be applied based on the value of the BI, as set out in paragraph 6.7.

- 6.2 Labuan bank shall calculate the BI as follows:

$$BI = IPC + SC + FC$$

where –

- (i) IPC is the Interest/Profit Component;
- (ii) SC is the Services Component; and
- (iii) FC is the Financial Component.

These components shall be calculated in accordance with paragraph 6.3.

6.3 Labuan bank shall calculate the IPC, SC and FC components as follows:

- (i) $IPC = \frac{\text{Min}[\overline{\text{Abs}(\text{interest income} + \text{profit income} - \text{interest expense} - \text{profit payable})}, 2.25\% \times (\overline{\text{interest earning assets} + \text{profit earning assets}})] + \overline{\text{dividend income}}}{\text{Abs}(\text{Net P\&L trading book}) + \text{Abs}(\text{Net P\&L banking book})}$
- (ii) $SC = \frac{\text{Max}[\overline{\text{other operating income}}, \overline{\text{other operating expense}}] + \text{Max}[\overline{\text{fee income}}, \overline{\text{fee expense}}]}{\text{Abs}(\text{Net P\&L trading book}) + \text{Abs}(\text{Net P\&L banking book})}$
- (iii) $FC = \frac{\text{Abs}(\text{Net P\&L trading book}) + \text{Abs}(\text{Net P\&L banking book})}{\text{Abs}(\text{Net P\&L trading book}) + \text{Abs}(\text{Net P\&L banking book})}$

where –

- (a) *Abs ()* is the absolute value of the item within the brackets;
- (b) The income statement items refer to the quarterly value (as recorded in Labuan bank's quarterly interim financial reports), and the balance sheet items³ refer to the carrying amount at the end of quarter, over the preceding twelve financial quarters⁴; and
- (c) A bar above the term indicates that the term is to be calculated as an annualised three-year average⁵.

6.4 In calculating the components in paragraph 6.3, Labuan bank shall comply with the additional requirements under **Appendix I**⁶.

6.5 Where Labuan bank has acquired a business or merged with another entity, Labuan bank shall include the BI of the acquired business or merged entity (as at prior to the effective date of the acquisition or merger) over the period that is relevant to the calculation of the BI under paragraph 6.2.

³ Interest-earning assets and profit-earning assets.

⁴ Income statement and balance sheet items are categorised into 12 quarters (equivalent to 3 years) consistent with the approach that had been adopted under *Banking Capital Adequacy Framework (Basel II – Risk-Weighted Assets)*, or as may be amended or modified by Labuan FSA.

⁵ A newly established Labuan bank which has been in operation for less than three years should calculate the IPC, SC and FC over the entire period since it commenced operations, with the components annualised accordingly.

⁶ Appendix I sets out the descriptions and examples of BI components, and the items to be excluded from the BI.

6.6 Unless otherwise approved by Labuan FSA, Labuan bank which has transferred a business⁷ or divested its shareholding in an entity to any other person shall continue to include the BI of the transferred business or business of the entity in which Labuan bank had divested its shareholding over the relevant period of its calculation of the BI under paragraph 6.2.

6.7 Labuan bank shall compute the BIC referred to in paragraph 6.1 as follows:

$$BIC = \sum_i (BI \times \alpha_i)$$

where –

- (i) Σ is the sum of the items within the brackets for all buckets, i ; and
- (ii) $BI \times \alpha$ is computed for each bucket, i , by multiplying the BI by the corresponding marginal coefficients that are assigned to each BI range in accordance with the table below:

Bucket, i	BI range (USD billion)	BI marginal coefficients, α
1	≤ 1	12%
2	$1 < BI \leq 30$	15%
3	> 30	18%

6.8 The BI marginal coefficients increase with the size of the BI. For Labuan banks in the first bucket (i.e. with a BI of less than or equal to USD1 billion), the BIC is equal to $BI \times 12\%$. The marginal increase in the BIC resulting from a one unit increase in the BI is 12% for Bucket 1, 15% for Bucket 2 and 18% for Bucket 3. For example, given a BI = USD35 billion:

$$BIC = (1 \times 12\%) + [(30-1) \times 15\%] + [(35-30) \times 18\%] = \text{USD5.37 billion}$$

⁷ For avoidance of doubt, this is referring to the transfer of business of a financial institution that falls under section 172 of the LFSSA or section 128 of the LIFSSA, as the case may be.

7.0 Internal Loss Multiplier (ILM)

- 7.1 Unless otherwise specified by Labuan FSA, Labuan bank shall set the ILM⁸ as 1.
- 7.2 Where Labuan FSA specifies that Labuan bank shall observe an ILM of greater than 1 after having regard to the operational risk profile of the Labuan bank and the adequacy of the risk mitigation measures that have been put in place, Labuan bank shall comply with the specification.

Labuan Financial Services Authority

DD/MM/YY

⁸ Labuan bank's internal operational risk loss experience may affect the calculation of operational risk capital requirements through the ILM.

Appendix I Definition of Components of the Business Indicator

1. Labuan bank shall calculate components of the BI based on the descriptions provided in the tables below⁹:
2. Non-exhaustive lists of examples of relevant sub-items from the income statement or balance sheet are also provided for guidance.
3. Unless otherwise stated, the measurement of the items under Tables 1, 2 and 3 below shall be in accordance with the relevant Financial Reporting Standards (FRSs).

Table 1: Interest/Profit component (IPC)

Items	Description	Examples
(a) Interest income	<p>Interest income from all financial assets and other interest income.</p> <p>This includes interest income from financial and operating leases, and profits from leased assets.</p>	<ul style="list-style-type: none"> • Interest income from financing and advances, assets at fair value through profit or loss, assets at fair value through other comprehensive income, assets at amortised cost, trading assets, financial leases and operational leases • Interest income from hedge accounting derivatives • Other interest income • Profits from leased assets
(b) Profit income ¹⁰	<p>Profit income from all financing, financial assets and other profit income.</p> <p>This includes profit income from leases/<i>ijarah</i> contracts and investment accounts.</p>	<ul style="list-style-type: none"> • Profit income from all financing, assets at fair value through profit or loss, assets at fair value through other comprehensive income, assets at amortised cost, trading assets, leases/<i>ijarah</i> contracts

⁹ This includes the clarifications set out in the Operational Risk reporting template.

¹⁰ For Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business. Any Shariah non-compliant sources of income shall be included under 'Other operating income' (See Item (c) under Table 2 below).

Items	Description	Examples
		<ul style="list-style-type: none"> Profit income from hedge accounting derivatives Other profit income not included in the above categories Profit share/<i>wakalah</i> fees income from investment accounts Profits from leased assets
(c) Interest expenses	<p>Interest expenses from all financial liabilities and other interest expenses.</p> <p>This includes interest expense from financial and operating leases, depreciation and impairment of, as well as losses from, operating leased assets.</p>	<ul style="list-style-type: none"> Interest expenses from deposits, debt securities issued, financial leases, and operating leases Interest expenses from hedge accounting derivatives Other interest expenses Losses from leased assets Depreciation and impairment of operating leased assets
(d) Profit payable ¹¹	<p>Profit payments on all financial liabilities and other return payments.</p> <p>This includes depreciation and impairment of, as well as losses from, leased assets.</p>	Expenses or returns payable on funds received from investment account holders, current account deposits, <i>sukuk</i> issued, <i>ijarah</i> /leases contracts
(e) Interest-earning assets	This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing financing).	Total gross outstanding financing, advances, interest-bearing securities (including government bonds), leased assets
(f) Profit-earning assets ¹¹	This includes all outstanding credit obligations in the balance sheet, including credit obligations on non-accrued status (e.g. non-performing financing).	Total gross outstanding financing, <i>sukuk</i> , other profit-bearing financial assets (including sovereign <i>sukuk</i>), leased assets

¹¹ For Labuan Islamic banks including Labuan banks undertaking Labuan Islamic banking business.

Items	Description	Examples
(g) Dividend income	Dividend income from investments in stocks and funds not consolidated in Labuan bank's financial statements, including dividend income from non-consolidated subsidiaries, associates and joint ventures.	

Table 2: Services component (SC)

Items	Description	Examples
(a) Fee and commission income	<p>Income received from providing advice and services.</p> <p>This includes fees received by Labuan bank for the supply of financial services.</p>	<p>Fee and commission income from:</p> <ul style="list-style-type: none"> Securities (issuance, origination, reception, transmission, execution of orders on behalf of customers) Clearing and settlement Asset management Custody Fiduciary transactions Payment services Structured finance Securitisations Financing/financing commitments and guarantees Foreign transactions
(b) Fee and commission expenses	<p>Expenses paid for receiving advice and services.</p> <p>This includes outsourcing fees paid by Labuan bank for the supply of financial services, but not outsourcing fees paid for the supply of non-financial services (e.g. logistical, IT, human resources).</p>	<p>Fee and commission expenses from:</p> <ul style="list-style-type: none"> Securities (issuance, origination, reception, transmission) Clearing and settlement Asset management Custody Fiduciary transactions Payment services Structured finance Securitisations Financing/financing commitments and guarantees Foreign transactions

Items	Description	Examples
(c) Other operating income	<p>Income from ordinary banking operations not included in other BI items.</p> <p>This excludes income from operating leases.</p>	<ul style="list-style-type: none"> Rental income from investment properties Gains from non-current assets and disposal groups classified as held for sale that do not qualify as discontinued operations under the acceptable FRSs For Labuan Islamic banks and Labuan banks undertaking Labuan Islamic banking business, income from non-Shariah compliant sources, if any
(d) Other operating expenses	<p>Expenses and losses from ordinary banking operations not included in other BI items, but of a similar nature and stemming from operational loss events.</p> <p>This excludes expenses from operating leases.</p>	<ul style="list-style-type: none"> Losses from non-current assets and disposal groups classified as held for sale that do not qualify as discontinued operations under the acceptable FRSs Losses incurred as a consequence of operational loss events (e.g. fines, penalties, settlements, replacement cost of damaged assets), which have not been previously provisioned/reserved for Expenses related to establishing provisions/reserves for operational loss events

Table 3: Financial component (FC)

Items	Examples
(a) Net profit/loss on the trading book	<ul style="list-style-type: none"> Net profit/loss on trading assets and trading liabilities (including derivatives, debt securities/sukuk, equity securities, financing and advances, short positions, other assets and liabilities) Net profit/loss from hedge accounting Net profit/loss from exchange differences
(b) Net profit/loss on the banking book	<ul style="list-style-type: none"> Net profit/loss on financial assets and liabilities measured at fair value through profit and loss

Items	Examples
	<ul style="list-style-type: none"> Realised gains/losses on financial assets and liabilities not measured at fair value through profit and loss (including financing and advances, assets at fair value through other comprehensive income, assets at amortised cost, financial liabilities measured at amortised cost) Net profit/loss from hedge accounting Net profit/loss from exchange differences

Excluded items

Labuan bank shall exclude the following items from the BI calculation:

- (i) income and expenses from insurance/takaful or reinsurance/retakaful businesses;
- (ii) premiums/contributions paid and reimbursements/payments received from insurance/takaful or reinsurance/retakaful policies/certificates purchased;
- (iii) administrative expenses, including staff expenses, outsourcing fees paid for the supply of non-financial services (e.g. logistical, IT, human resources) and other administrative expenses (e.g. IT, utilities, telecommunications, travel, office supplies, postage);
- (iv) recovery of administrative expenses including recovery of payments on behalf of customers (e.g. taxes debited to customers);
- (v) expenses of premises and fixed assets (except when these expenses result from operational loss events);
- (vi) depreciation/amortisation of tangible and intangible assets (except depreciation related to operating lease assets, which should be included in financial and operating lease expenses);
- (vii) provisions/reversal of provisions (e.g. on pensions, commitments and guarantees given) except for provisions related to operational loss events;
- (viii) expenses due to share capital repayable on demand;
- (ix) impairment/reversal of impairment (e.g. on financial assets, non-financial assets, investments in subsidiaries, joint ventures and associates);
- (x) changes in goodwill recognised in profit or loss; and
- (xi) corporate income tax (tax based on profits including current and deferred tax).