

2013

REGULATORY AND SUPERVISORY FRAMEWORK

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The regulatory and supervisory framework continued to play a critical role in promoting conditions for financial stability, while supporting the development of the financial sector. The Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) came into force in June 2013, providing the Bank with enhanced powers to effectively perform its regulatory and supervisory roles in an increasingly complex financial landscape. Following this, the Bank's regulatory priorities have been directed at giving full effect to the new laws, including a re-orientation of the focus of financial supervision beyond individual financial institutions to take into account group-wide and system-wide risks. The year also saw the prudential framework strengthened in line with international regulatory reforms. This included the implementation of strengthened capital standards under Basel III and enhanced requirements on exposures to single counterparties. The Bank also continued to advance its work to further strengthen the liquidity standards for banking institutions, alongside broader initiatives to promote sound risk management practices in the financial industry.

The Bank's regulatory priorities have been directed at giving full effect to the new laws

Focus continued to be given to strengthening safeguards against threats of money laundering and terrorism financing. Further progress has been made in raising the standards of compliance with measures to combat these threats in the money services business industry. The Bank also intensified its review of the effectiveness of anti-money laundering and countering the financing of terrorism (AML/CFT) controls within financial institutions. Enforcement and supervisory actions were pursued against financial institutions that failed to effectively control money laundering and terrorism financing risks in their operations. These measures served to ensure that financial institutions remain alert to these risks, including emerging threats, and are taking appropriate measures to protect the integrity of the financial system.

STRENGTHENING THE PRUDENTIAL FRAMEWORK

Regulation and supervision of financial groups

The FSA and IFSA include provisions for the oversight of financial groups by the Bank to ensure that risks from the activities of licensed institutions' affiliates are appropriately managed and controlled. This represents a substantive enhancement to the legal framework for the financial sector and paves the way for the Bank to put in place a prudential framework for financial groups that would reinforce the existing entity-focused prudential framework to protect depositors and policyholders. Such a framework will become increasingly important as financial institutions offer innovative products and enter new geographical markets in pursuit of greater growth and diversification.

Following an extensive review of group structures and the nature and scope of group activities observed in Malaysia, the Bank outlined its intended approach to overseeing financial groups in early 2014. The Bank clarified how the boundaries of a financial group will be drawn for the purpose of prudential regulation and supervision, and correspondingly, the scope of regulation and supervision that will apply. In general, the Bank will hold a licensed institution or a financial holding company which is at the apex of a financial group responsible for ensuring compliance with group-wide prudential standards – including those on capital adequacy and liquidity, corporate governance and risk management. The apex entity will also serve as a focal point for supervisory activities, such as obtaining information for the purposes of assessing risks to the financial health of the group. These group-wide standards will complement the traditional regulatory and supervisory focus on the licensed institution on a standalone basis, by ensuring that the prudential framework also addresses risks to the licensed institution that may arise as a result of its associations and interdependencies with other entities within a financial group and the wider group. Where these entities are regulated by other authorities, the Bank will cooperate closely

with the relevant domestic and foreign regulatory authorities in ensuring that financial groups meet the required prudential standards. This includes cooperation with the home supervisory authorities of foreign-owned licensed institutions to ensure that the operations in Malaysia are subject to supervision and regulation that adequately addresses group-wide risks to the licensed institutions in Malaysia.

For groups with multiple entities operating in both the banking and insurance or takaful sectors, a separation will be required between the banking and the insurance or takaful entities. This allows group-wide capital standards which are central to the prudential framework to be applied in a meaningful way for groups of entities that operate in the two distinct sectors. The separation is also intended to ensure that the Bank and financial groups have a clear focus on the management and control of group-wide risks to banking institutions and insurance or takaful entities. Where an approved financial holding company is itself part of a wider industrial conglomerate, the Bank may require additional safeguards to be in place to mitigate contagion risks to the financial group and licensed institutions within it. This could include requirements to ensure that intra-group exposures are within prudent limits.

Group-level prudential standards will be gradually rolled out beginning from 2014

Most of the largest domestic banking groups are already headed by licensed banking institutions or financial holding companies designated by the Bank prior to the enactment of the FSA and IFSA. These will continue to serve as the apex entities for the purpose of group-wide supervision and regulation under the FSA and IFSA. For the remaining financial groups, the Bank expects to approve the relevant apex entities in the first half of 2015. An approved apex entity will be responsible for establishing and implementing group-wide policies and procedures that ensure the financial group's compliance with prudential requirements on a consolidated basis. This would also provide the Bank with an adequate view of material group-wide risks which may affect the licensed institution.

Group-level prudential standards will be gradually rolled out beginning from 2014. The first set of standards which relate to capital adequacy for banking groups headed by financial holding companies will be published for industry feedback in the first half of 2014. This will be followed by standards on corporate governance and risk management for all financial groups, and standards on liquidity management for banking groups.

The development of a capital adequacy standard for insurance groups is also planned, although not for the immediate term. This will allow the Bank to take into account the outcome of current work by the International Association of Insurance Supervisors (IAIS) to develop a global insurance capital standard which will provide an internationally harmonised approach to dealing with cross-border exposures. The proposed group capital adequacy standard will also be developed to address the combined risk exposures of conventional and takaful operations. At present, most insurance groups in Malaysia do not have material operations outside Malaysia or in non-insurance sectors. A small number of insurance groups are active in the fund management industry which is regulated by the Securities Commission. These factors currently limit the potential for contagion risk to threaten the safety and soundness of licensed insurance and takaful entities pending the implementation of group-wide capital standards for insurance groups in Malaysia.

Capital adequacy and liquidity requirements in the banking sector

Higher regulatory capital standards under the Basel III reform package were implemented in Malaysia beginning from 1 January 2013. In addition to raising the minimum required capital levels, the quality of the capital buffers in the banking system is being further enhanced through the requirements for capital instruments to have clear loss-absorbing features, such as the conversion to equity or write-off of instruments when a banking institution is no longer viable. A more prudent calculation of capital has also been adopted to account for, among others, the higher degree of uncertainty associated with valuations of certain financial instruments and properties.

Banking institutions continue to maintain strong capital positions under the higher capital standards and support domestic intermediation activities. The Common Equity Tier 1 capital ratio of the Malaysian banking system stood at 12.1%

as at end-2013, well above the 3.5% required in 2013 and 4.0% set to take effect in 2014. The year also saw banking institutions continue to use dividend reinvestment programmes and issue new Basel III compliant capital instruments to further strengthen capital buffers ahead of the timeline for the regulatory requirements to take full effect. As at end-2013, six banking institutions have raised over RM3.3 billion in Tier 2 capital instruments which meet the higher loss absorbency requirements.

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The calibration of new liquidity standards which are consistent with Basel III standards is also well advanced. As earlier announced by the Bank, these standards will be implemented in Malaysia in 2015. Following the revision to the Liquidity Coverage Ratio (LCR) by the Basel Committee on Banking Supervision in January 2013 to incorporate amendments to the definition of high-quality liquid assets (HQLA) and refinements to the cash inflow and outflow rates, the Bank updated its 'observation period' reporting requirements in July 2013 to facilitate its assessment of the quantitative impact of the new rules on the domestic banking sector. While the LCR is conceptually similar to the existing liquidity framework in place in Malaysia, the broader and more granular measurement of liquidity risk exposures under the LCR will reinforce the resilience of the banking system against severe liquidity shocks.

Banking institutions have improved their information capture and reporting systems to comply with reporting requirements on their liquidity positions based on the Basel III standards. The reporting requirements were introduced in 2012 as part of an observation period prior to the finalisation of the liquidity rules that will be adopted in Malaysia. While the actual LCR positions will be determined based on how the parameters are ultimately calibrated under the Bank's final liquidity rules, indicative reports suggest that the average LCR of the banking sector as at end-2013 stood at over 90%, with the majority of banking institutions reporting LCR

positions in excess of 100% – well above the minimum compliance level of 60% which will be required in 2015 under Basel III. However, these positions are expected to further improve as banking institutions continue to strengthen their funding positions – including by diversifying funding sources, developing new products such as fixed maturity term deposits with explicit restrictions on early withdrawal, and issuing long-term senior debt – and enhance the quality of internal systems for capturing and reporting liquidity risk information.

Data from the observation period reports also indicate that a large portion of the stock of HQLA held by banking institutions is of the highest quality, falling within the definition of 'Level 1' assets. These Level 1 assets – defined as assets which can be easily and immediately converted into cash at little or no loss of value even in times of stress, and which include securities issued or guaranteed by sovereigns and central banks – account for nearly 80% of HQLA reported, well above the 60% minimum specified in the rules. The remainder of the HQLA reported consists of 'Level 2' assets which include highly-rated corporate debt securities. Although the Basel Committee also allows for the limited recognition of lower-rated corporate debt securities, listed equities and residential mortgage-backed securities within Level 2 assets, these form only a small proportion (4%) of the stock of HQLA held by banking institutions. The domestic bond and sukuk market, which is one of the largest and deepest in the region, is expected to continue to provide sufficient supply of HQLA to meet the aggregate liquidity buffer needs of the banking system. As at end-2013, ringgit-denominated marketable securities which are eligible to be counted as Level 1 HQLA were valued at RM636.6 billion. Over the last five years, net issuances of ringgit-denominated HQLA grew by around 13% annually. This augurs well for the provision of a steady supply of assets to meet the needs of the banking system going forward.

An important consideration for the liquidity framework in Malaysia is the significance and unique characteristics of wholesale funding which accounts for more than 60% of total deposits accepted. A proportion of these wholesale funds in the banking system represents deposits placed by mandatory savings schemes such as the Employees Provident Fund and other retirement schemes. As these savings play a

key role in channelling a significant portion of funding from households to the banking sector, the proposed liquidity rules to be adopted in Malaysia will consider options for the treatment of such schemes. The treatment will consider, among others, the underlying stability of these funding sources and any restrictions placed on the investments abroad.

The domestic bond and sukuk market is expected to continue to provide sufficient supply of HQLA to meet the aggregate liquidity buffer needs of the banking system

The Bank expects to publish a concept paper on the new liquidity standards by mid-2014. In addition to the treatment of wholesale deposits, the proposals will address the scope of Level 2 assets that can be recognised as HQLA, the treatment of contingent funding obligations for which run-off rates are not specified by the Basel Committee, and the treatment of funding mismatches across currencies.

Qualitative requirements will also continue to play an important role in the regulatory and supervisory framework to ensure sound liquidity management practices by banking institutions. This was reflected in recent enhancements made to the Bank's risk-based supervisory framework to further strengthen the emphasis on supervisory assessments of liquidity risk. The Bank also plans in the near term to issue standards on the management of liquidity risk with the aim of elevating industry practices in areas such as stress testing and contingency planning, the setting of liquidity risk limits and liquidity transfer pricing. These standards will take into account current supervisory observations on liquidity risk management practices, and will reinforce the use of liquidity metrics such as compliance with the LCR and Net Stable Funding Ratio to further enhance the resilience of the banking system to liquidity stresses.

Limit on exposures to single counterparties

Enhanced regulatory requirements on exposures of banking institutions to a single counterparty

(also referred to as the Single Counterparty Exposure Limit or SCEL) were introduced on 1 March 2013. The SCEL serves as a backstop measure to avoid excessive concentrations in risk exposures that could materially threaten a banking institution's financial position. The key changes in the regulatory requirements were: (i) a broader definition of 'exposures' to better capture the different ways in which a banking institution may be financially exposed due to a deterioration in the credit standing of a counterparty; (ii) some scope for banking institutions to use credit risk mitigants as a way to expand their exposures to a single counterparty; and (iii) greater clarity provided for the aggregation of exposures to connected counterparties.

Following further feedback from the industry and additional data analysed by the Bank during the initial implementation period, the Bank made further refinements to the SCEL in December 2013 to mitigate the impact of the requirements on underwriting and hedging activities which did not materially increase concentration risks to banking institutions. Banking institutions are required to fully comply with the revised requirements by 1 March 2015.

Capital adequacy requirements in the insurance and takaful sectors

The Risk-Based Capital Framework for Takaful Operators (RBCT) came into effect on 1 January 2014 following a one-year parallel run. In preparation for the adoption of the RBCT, takaful operators undertook broad efforts in 2013, including a review of business and investment strategies, to improve risk profiles and strengthen risk management practices. This helped to achieve a smooth transition into the new regime. The risk-aligned capital charges under the RBCT significantly strengthen incentives for sound risk underwriting, and its implementation has seen takaful operators make significant investments in improving IT and management information systems that support more effective analysis and monitoring of risks. Aside from ensuring that takaful operators are well-capitalised, the Bank expects continued and accelerated improvements in risk management practices adopted by takaful operators as a result of the increased emphasis that the RBCT places on the boards and management of takaful operators to have in place effective capital management plans and strategies.

One of the objectives of the capital framework for financial institutions is to improve the consistency of standards across the banking, insurance and takaful sectors where appropriate. Accordingly, the Bank will consider the relevance of refinements being introduced under the capital adequacy framework for banking institutions to that for insurers and takaful operators. The Bank does not expect to make any substantive changes to the existing frameworks until work is more advanced on the development of a global insurance capital standard by the IAIS. Nevertheless, the Bank will proceed to identify changes necessary to update the valuation standards that apply to financial instruments and insurance contracts under the Risk-Based Capital Framework for Insurers (RBC) and RBCT in line with the adoption of new Malaysian Financial Reporting Standards which are consistent with International Financial Reporting Standards.

The Risk-Based Capital Framework for Takaful Operators came into effect on 1 January 2014 following a one-year parallel run

Internal capital adequacy assessments

Beyond the minimum regulatory capital requirements which banking institutions, insurers and takaful operators must comply with under the respective capital adequacy frameworks, a financial institution is also required to conduct an Internal Capital Adequacy Assessment Process (ICAAP) to ensure that it maintains adequate capital on an ongoing basis to support its business operations and to manage any unanticipated risks that may affect its financial position.

In the banking sector, the Bank completed a second review of individual banking institutions' ICAAPs during the year against the expectations set out in the ICAAP guidelines that were issued by the Bank in 2010. The reviews were focused on assessing not only the level of observance of institutions' ICAAPs to the Bank's guidelines, but also the effectiveness of these frameworks in delivering the intended sound risk and capital outcomes.

The Bank observed further advances by the banking industry in strengthening the

fundamental building blocks of the ICAAP, including the adoption of more forward-looking approaches to capital management and the use of more rigorous risk measurement techniques. A heightened level of engagement by the boards of directors and senior management in the oversight of the ICAAP was also observed, with the ICAAP serving as an increasingly important tool to integrate business strategy, risk management and capital management decisions in banking institutions. Notably, the establishment of more formal risk appetite frameworks has gained traction within the banking industry, serving to draw a clearer link between an institution's capital position and the risk exposures arising from business activities. This in turn is being used to guide strategic and business plans in a larger number of banking institutions. Banking institutions also continue to invest in information systems and reporting infrastructure to support the ICAAP, thus enhancing the decision making process.

As part of the ICAAP, banking institutions are also required to set internal capital targets that reflect their risk profiles and business plans, and develop strategies for achieving and maintaining these target capital levels. The Bank has observed the wider adoption of formal internal capital targets across banking institutions, with the majority of banking institutions targeting Total Capital ratios of 12% or more. However, the capital planning process can be further improved, in particular by strengthening the stress testing process to reflect more robust approaches to the identification of scenarios and assumptions of future economic and operating conditions. A diverse range of scenarios and assumptions should aid the evaluation of capital targets and the impact of adverse events on capital levels. Banking institutions should also consider further enhancing mechanisms in place to monitor and credibly maintain capital levels in line with internal capital targets and approved capital plans.

In the insurance sector, life and general insurers have been required to conduct the ICAAP since 2012 to reinforce the internal capital targets that insurers must comply with under the RBC. As with banking institutions, the Bank has similarly observed that insurers have accorded greater emphasis to the interaction between risk and capital, specifically through the development of risk appetite statements and the formalisation of capital management plans. Even so, there

remains scope for further integrating risk appetite frameworks with capital management policies. The Bank has also encouraged insurers to ensure that capital management plans provide clear guidance on remedial actions that will be taken when key capital thresholds are breached. As part of the supervisory process, the Bank will continue to review the implementation of ICAAP by insurers and evaluate progress made in closing any identified gaps. In the takaful sector, following the implementation of the RBCT, expectations on the conduct of the ICAAP by takaful operators will be issued in 2014. While this will be largely similar to the ICAAP for insurers, it will also take into consideration business models which are unique to takaful operators and the specificities of Islamic contracts that takaful operators enter into.

Role of actuaries

Appointed actuaries have an important role within the prudential framework in promoting the sound financial management of insurers and takaful operators. The prudential framework places responsibility on the appointed actuary for certifying the adequacy of reserves held by insurers and takaful operators to meet policy liabilities. Appointed actuaries are also responsible for preparing the financial condition report of the insurer or takaful operator as a basis for the board's oversight of the institution's financial affairs. The financial condition report is also used in supervisory assessments by the Bank. During the year, the Bank undertook a review to strengthen existing prudential standards on appointed actuaries. The Bank published its proposals, which reflect international best practices, for industry feedback in June 2013. In line with the expanded scope of provisions on appointed actuaries in the FSA and IFSA, the proposals will also be applicable to actuaries appointed by general insurers and takaful operators.

Proposals were made to enhance the stature of the appointed actuary by requiring the appointed actuary to have direct access to the board, and to ensure that actuaries take a more active role in raising the level of board and management understanding of actuarial issues. This includes a stronger emphasis on ensuring that the communication of actuarial issues is clear and timely, and the risk and financial implications of the issues are fully understood by those who are not experts in the field. Proposals were also directed at strengthening the effectiveness of the control function which is performed by

the appointed actuary. This included proposals that require the appointed actuary to be in the full-time employment of the insurer or takaful operator, and a clearer separation of the appointed actuary from pricing responsibilities which may conflict with his/her duties to certify the adequacy of insurance or takaful reserves.

Feedback from the industry has been mainly concerned with the demands that the proposals are likely to place on the actuarial talent pool in Malaysia. These demands are expected to be more pronounced in the general insurance and takaful industry. The Bank acknowledges that a pragmatic approach which includes appropriate transitional arrangements, with longer-term initiatives to further develop the actuarial talent pool, are likely to be needed in implementing the enhanced standards and to support the future expansion of domestic insurance and takaful operations. The Bank is close to finalising the standards which will reflect these considerations.

Standards were issued to promote the sound pricing of retail loans and financing products

Risk-informed pricing of retail loans

In 2013, standards were also issued to promote the sound pricing of retail loans and financing products. This is not only important for the long-term viability of lenders, but also to promote a sound credit market. While lending standards have generally remained prudent across the banking and development finance sectors, more aggressive pricing practices due to heightened competition have been observed in the retail lending space. This can increase portfolio risks especially where pricing models that are insufficiently robust do not allow lenders to identify and manage mispriced risk segments. The risk-informed pricing standards aim to mitigate this risk by requiring lenders to produce realistic estimates of the costs and expected losses of the different retail loan and financing product segments, and ensure that the implications of a chosen pricing strategy are well understood and reflected in a lending institution's capital and risk management plans. Over the last two years since the Bank first shared plans to put the standards in place, lenders have made considerable progress in

addressing important data and systems gaps which had constrained the adoption of the standards at an earlier date. The standards will now come into effect in March 2014.

Islamic investment accounts

Reflecting the continuing evolution of the Islamic financial system in Malaysia, the IFSA introduced a clear distinction between 'Islamic deposits' and 'investment accounts' in line with Shariah. Under the law, the terms of an investment account must not guarantee the repayment of principal and return on monies paid into the account; this will depend on the performance of assets underlying the account. Given the higher inherent risks to investors from these accounts relative to deposits, standards were proposed by the Bank in March 2013 to promote the sound management of such investment accounts. The proposals cover requirements to ensure that proper oversight and risk management arrangements are in place to manage the investments underlying these accounts and uphold compliance with Shariah. The proposals also address duties on disclosure and fair dealing for the protection of investors. Banking institutions will have to comply with the final requirements by June 2015, when the separation between Islamic deposits and investment accounts takes full effect under the law after a two-year transition period.

SAFEGUARDING THE INTEGRITY OF THE FINANCIAL SYSTEM

Money services business industry

Together with heightened supervisory activities, the strengthened regulatory regime under the Money Services Business Act 2011 (MSBA) continued to support the orderly development of the money services business industry. This industry comprises the money changing, remittance services and wholesale currency businesses.

In 2013, marked improvements continued to be observed in the record keeping practices of money services providers. This was reflected in the increased use of computerised systems and better documentation of money services business transactions. Money services providers have also put in place AML/CFT policies and procedures. These range from basic frameworks prevailing among the smaller entities, to more comprehensive arrangements in place within the larger entities. The Bank continues to work with the industry to improve the effectiveness of AML/CFT policies and practices

across the industry, with education, supervisory engagements and enforcement actions being important levers used by the Bank to achieve this.

During the year, the number of licensed entities reduced further to 474 from 515 in 2012. This was the result of the further consolidation of the industry and the surrender of licenses by smaller entities which opted to become agents of larger and more established money service providers. The number of agents correspondingly increased to 208 in 2013, including licensed entities that are approved to be agents in a different money services business line. These structural changes have produced greater business synergies and enabled more effective supervision and control of money services providers while promoting a healthy level of competition. There are presently ten principal licensees that are allowed to appoint agents, and these serve an important role in raising industry standards and strengthening safeguards against the risk of abuse of the industry for illegal purposes. The principal licensees are expected to provide effective oversight, training and systems that ensure compliance by the agents with regulatory requirements. These expectations are clearly set out in the money services business agent oversight framework issued by the Bank. In supervising the industry, the Bank also reviews the effectiveness of agent oversight arrangements implemented by principal licensees.

Two important outcomes of the enhanced regulatory and supervisory framework for money services business are providing wider public access to money services through formal channels and improving the capture of money services business transactions. Substantial progress has been achieved on both counts as evidenced by higher outward remittances in 2013 totalling RM25.1 billion, an increase of 27% from RM19.7 billion recorded in 2012. Of this amount, remittance agents accounted for about RM1 billion involving 1.1 million transactions, reflecting greater access to authorised remittance channels through the broader branch and agent network. At the same time, the money changing business turnover expanded further by 22% to RM52 billion, compared to RM42.5 billion in 2012, largely due to improvements in record keeping systems.

In the wholesale currency business sector, RM4.6 billion in domestic transactions were

recorded in 2013, an increase of 35% from the RM3.4 billion reported in 2012. This growth was supported by sustained demand for the exchange of foreign currencies, as well as the increasing presence of currency wholesalers throughout Malaysia which provided more reliable, efficient and cost-competitive services to meet the needs of licensed money changers for sourcing and clearing foreign currencies. The enlarged presence of currency wholesalers has also helped to reduce the risks associated with alternative means for obtaining foreign currency from questionable sources.

The Malaysian Association of Money Services Business was launched in January 2014 with the aim of building capacity and elevating professionalism in the money services industry

The Malaysian Association of Money Services Business, which was launched in January 2014, is expected to complement the Bank's efforts in driving and implementing initiatives to build capacity and raise standards of compliance and professionalism across the money services industry. The immediate priorities of the association are to develop a code of professional and ethical conduct for the industry; provide training and education on requirements under the relevant laws and sound business practices, including in respect of AML/CFT compliance; promote awareness among consumers of their responsibility to deal only with authorised money services providers; and facilitate constructive engagements with the Bank to achieve the consistent and effective implementation of regulatory requirements across the industry.

Assessment of Malaysia's AML/CFT framework against international standards

As a highly open economy, Malaysia is committed to safeguarding its financial system from being used to harbour or channel illegal funds linked to criminal and terrorist activities. Through its membership in the Asia/Pacific Group on Money Laundering (APG), Malaysia undergoes a periodic Mutual Evaluation Exercise to assess its conformity with international AML/CFT standards. A peer review exercise is scheduled to take place in 2014, following a similar exercise conducted in

2007. The assessment in 2014 will be based on the standards of the Financial Action Task Force (FATF) Recommendations which were enhanced in 2012. This review will also employ a more rigorous evaluation methodology which extends beyond an assessment of the technical compliance with provisions of the AML/CFT framework to include an appraisal of its effectiveness in deterring and preventing the use of the financial system to launder criminal proceeds or fund terrorist activities. The Bank considers the upcoming review as an opportunity to identify areas for further enhancing the AML/CFT regime in Malaysia.

The recent years have seen the Bank make significant strides in enhancing the AML/CFT framework, including the improvements articulated in the box article 'Strengthening the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) Framework'. The Bank, in collaboration with other Ministries and law enforcement agencies, also initiated a broad national-level effort in 2013 to identify and understand the money laundering and terrorism financing risks faced by the country. In line with international practice advocated by the FATF, this national risk assessment (NRA) aims to identify key vulnerabilities and risks across various sectors in the country. This will assist in prioritising the deployment of resources to tackle high-impact risks in a more effective and targeted way, including through a heightened supervisory focus on identified sectors or entities that are assessed to be of higher risk.

A peer review exercise with the Asia/Pacific Group on Money Laundering is scheduled to take place in 2014

Supervisory review on financial institutions' AML/CFT practices

Given the role of financial institutions in financial intermediation and in channelling flows of funds across borders, the financial system remains the focal point of the Bank's initiatives to combat money laundering and terrorism financing.

Supervisory reviews in recent years have revealed that most financial institutions have in place the necessary programmes to address evolving threats of money laundering and terrorism

financing. A thematic review conducted by the Bank in 2013 showed that a number of financial institutions were increasing investments in information systems. The management of AML/CFT risks is also being more closely integrated with the overall risk management functions of these institutions. The Bank has further observed a greater level of awareness among board members and senior management about the risks and implications of money laundering and terrorism financing. In respect of suspicious transaction reports (STRs), a general improvement in the STR quality has been observed in practices across financial institutions. Nonetheless, the Bank notes that a number of financial institutions have yet to fully develop and implement proper systems to facilitate effective ongoing monitoring of customer accounts and its pattern of transactions, leading to non-reporting of STRs in some instances. There is also scope for financial institutions to further improve how front-line employees conduct customer due diligence (CDD) and assess money laundering and terrorism financing risks when dealing with prospective and existing customers.

Enforcement

The effective enforcement of laws and regulations is critical to national efforts to protect the financial system from abuse. The Bank investigates and pursues criminal actions against offenders of the laws it administers. During the year, the Bank brought 1,823 charges against companies and individuals investigated for operating illegal schemes and activities (Table 3.1). A number of these enforcement actions were pursued jointly with other Ministries and law enforcement

agencies – such as the Companies Commission of Malaysia, the Inland Revenue Board of Malaysia and the Ministry of Domestic Trade, Co-operatives and Consumerism – particularly where the offences cut across the jurisdiction of other domestic authorities. In cases where the Bank is not directly involved in prosecuting an offence, the Bank plays a role in providing financial intelligence to the relevant authorities.

In addition to criminal sanctions, enforcement is also supported by administrative and civil actions which the Bank initiates against its regulated institutions for non-compliance. In particular, monetary penalties are imposed on financial institutions for failures to implement appropriate AML/CFT compliance measures. Such sanctions play an important role in complementing other supervisory actions to ensure that financial institutions effectively discharge their responsibilities for detecting and deterring money laundering and terrorism financing. In 2013, monetary penalties amounting to RM0.7 million were imposed on two banking institutions and eight money changers for various non-compliances with the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA) and AML/CFT standards. In the money services business industry, actions were taken against 24 entities in 2013. These include the imposition of monetary penalties for non-compliance with various regulatory and operational requirements under the Money-Changing Act 1998 and MSBA amounting to RM0.6 million and the removal of key responsible persons for more serious offences.

Table 3.1

Enforcement Actions Taken in 2013

Illegal deposit taking	<ul style="list-style-type: none"> 16 charges under section 25(1) of the Banking and Financial Institutions Act 1989 against two companies and seven individuals.
Money laundering	<ul style="list-style-type: none"> 1,793 charges under section 4(1) of the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA) against 33 individuals and companies involving RM8.3 billion and 11 kg of gold. One civil forfeiture application under section 56(1) of the AMLATFA filed against two respondents involving RM129,275.
Unauthorised provision of money services	<ul style="list-style-type: none"> Revocation of licence of one money changer under the Money-Changing Act 1998 (MCA) for unauthorised provision of money remittance services. 14 charges under the MCA and the Money Services Business Act 2011 against 11 entities, of which seven have been convicted.

Strengthening the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) Framework

In recognition of the increasing threats from money laundering and terrorism financing (ML/TF) in recent years, many countries including Malaysia have intensified efforts to develop and maintain an AML/CFT regime that is robust and can effectively respond to the constantly evolving risks and vulnerabilities. These efforts are aimed at protecting the integrity of the financial system and the economy. The AML/CFT regime in Malaysia is characterised by four pillars - a comprehensive legal framework, implementation of preventive measures, effective enforcement of laws and regulation and close cooperation between agencies, both domestically and internationally.

The first pillar is a comprehensive legal framework that provides for a wide range of ML/TF offences, sufficient powers of investigation and prosecution for relevant law enforcement agencies and a broad range of proportionate and dissuasive sanctions.

This is reinforced by the second pillar - the implementation of preventive measures to detect and deter ML/TF activities in financial transactions undertaken by financial institutions as well as designated non-financial businesses and professions (DNFBPs)¹. The Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA) and relevant regulatory requirements collectively aim to ensure that reporting institutions implement the necessary preventive measures and establish AML/CFT risk controls and programmes that are commensurate with the ML/TF risks associated with the profile of their business. Efforts are currently underway to further strengthen the AMLATFA and regulatory requirements in response to new and emerging risks, and to reflect industry practices that have evolved in managing ML/TF risks.

The third pillar is the effective enforcement of the laws and regulations to promote an environment that dissuades ML/TF activities. Investigations and enforcement actions are carried out by the relevant law enforcement agencies and supported by timely financial intelligence. As the competent authority under the AMLATFA, the Bank serves as the Financial Intelligence Unit (FIU) which is responsible for analysing reports submitted by the reporting institutions and disseminating financial intelligence to the relevant law enforcement agencies. The FIU also conducts supervisory and enforcement activities on reporting institutions under the Bank's purview.

The fourth pillar is the close cooperation and coordination between agencies both in Malaysia and across borders. Domestically, the National Coordination Committee to Counter Money Laundering (NCC) which was established since April 2000 plays an important role in strengthening cooperation between the various agencies involved in combating ML/TF and in coordinating inter-agency strategic and policy initiatives. This has included joint efforts in investigating and prosecuting crimes that involve multiple law enforcement agencies. At the international level, membership in the Egmont Group of Financial Intelligence Units provides Malaysia with a platform to cooperate particularly in the areas of training and sharing of information. Cooperation with international counterparts also continues to be forged. In 2013, the Bank signed two Memoranda of Understanding (MoUs) with the financial intelligence units of the Republic of South Africa and St Kitts-Nevis, bringing the total number of such MoUs in place so far to 37.

Amendments to the AMLATFA

During the year, the Bank under the ambit of the NCC proposed several amendments to the AMLATFA and revised the existing regulatory requirements in line with global standards and to ensure that the AML/CFT framework remains relevant and effective in combating ML/TF threats.

¹ Designated non-financial businesses and professions (DNFBPs) include casino, lawyers, accountants, dealers of precious metals and stones, gaming business, money lenders, pawn brokers, trust companies and real estate agents.

The proposed amendments to the AMLATFA were tabled for the first reading in Parliament in December 2013. The proposed amendments are aimed at:

(i) Enhancing clarity of reporting obligations

The amendments will clarify regulatory expectations and obligations of reporting institutions when conducting customer due diligence (CDD), including an expansion of the requirements relating to document retention. The amendments will also include an explicit requirement for reporting institutions to submit suspicious transaction reports (STRs) on suspicion of terrorism financing. To safeguard the confidentiality of information reported to the Bank, specific amendments are also being proposed to criminalise the act of tipping-off customers after an STR has been submitted to the Bank.

(ii) Strengthening measures on declaration for cross-border transportation of cash / bearer negotiable instruments (BNIs)

Reflecting heightened international concerns with cross-border transportation of cash or BNIs for ML/TF purposes, requirements on cash declarations will be expanded to include transportation of cash or BNIs via cargo, mail or other means as well as new requirements on the declaration of cash received from outside Malaysia. The amendments also provide specific powers for enforcement authorities to seize any undeclared cash or BNIs.

(iii) Widening the scope of offences and strengthening enforcement powers

The proposed amendments will expand the scope of money laundering offences to include any thing or any property which is used in connection with the commission of a serious offence in addition to expanding the definition of proceeds of an unlawful activity. The practice of structuring transactions in order to evade cash threshold reporting requirements will also be made an offence.

Provisions relating to the freezing, seizure and forfeiture of assets under investigation will be enhanced, by including the power to vary or revoke an order to freeze property. To ensure that penalties serve as a credible deterrent, the amendments will increase the maximum penalty for an ML offence to 15 years imprisonment, and a fine of not less than five times the sum or value of the proceeds of unlawful activity or instrumentalities of an offence at the time the offence was committed, or RM5 million, whichever is higher.

Revised Regulatory Requirements

The AML/CFT requirements, first issued under the AMLATFA in 2006 were also revised in 2013 to support the more effective implementation of AML/CFT measures by both regulators and reporting institutions. This included changes that would promote a more consistent application of AML/CFT requirements throughout the financial sector including the securities industry and financial institutions in the Labuan International Business and Financial Centre. The requirements were also enhanced by incorporating higher expectations following the recent changes in international AML/CFT standards.

The revised regulatory requirements reflect a stronger emphasis on the implementation of a risk-based approach to the management and control of ML/TF risks. This approach seeks to ensure that AML/CFT measures implemented by reporting institutions are proportionate to risk, while responding to concerns that the indiscriminate implementation of AML/CFT measures can result in the exclusion of legitimate consumers and businesses from the formal financial system.

The Bank revised and issued five AML/CFT policies to the financial sector, including the money services business sector, DNFBPs and non-financial sector, which came into effect in September 2013 and November 2013 respectively. The revisions cover the following areas:

(i) Introduction of a risk-based approach to AML/CFT

Reporting institutions are now required to adopt a risk-based approach to identify, assess, and mitigate the ML/TF risks associated with their products, services and operations. This includes requirements for reporting institutions to conduct comprehensive risk assessments and risk profiling of customers, and to implement the appropriate internal controls, policies and procedures to prevent their businesses from being used as a conduit for ML/TF.

(ii) Refined and strengthened CDD requirements

Taking into consideration the average transaction size and feedback from enforcement agencies, the CDD thresholds for money changing transactions were revised downwards from RM20,000 to RM3,000 and RM10,000. Reporting institutions are now required to sight and record the identification information of the customer or beneficial owner for transactions above RM3,000; whilst for transactions above RM10,000, reporting institutions are also required to retain a copy of the identification document. The revised thresholds would further strengthen safeguards against ML/TF risks in the money services business sector.

In line with efforts to promote greater financial inclusion, the list of identification documents which can be accepted for CDD verification purposes has also been expanded. The revised requirements allow the use of any official document bearing the photograph of the customer or beneficial owner, provided that the reporting institution is satisfied with the authenticity of the document presented.

To streamline the requirements with international standards, the requirements relating to politically exposed persons (PEPs) have been extended to include domestic PEPs² and persons entrusted with prominent functions by an international organisation. Reporting institutions are now required to take reasonable measures to determine whether a customer or beneficial owner is a domestic PEP or person entrusted with prominent functions by an international organisation, perform a risk assessment, and apply the appropriate CDD measures for the level of risk identified.

(iii) Enhanced requirements on AML/CFT compliance programme

Revised requirements were introduced to raise standards of compliance by reporting institutions. This included higher expectations placed on the compliance function and requirements for compliance officers to meet minimum 'fit and proper' criteria. An important objective of these requirements was to ensure that reporting institutions give adequate priority to AML/CFT activities in the key business activities of the institution, and to enhance the role of compliance officers in driving AML/CFT improvements within the reporting institutions. Considering the significance of the banking and insurance sectors in the financial system, the Bank introduced additional requirements to ensure that compliance officers in these financial institutions have sufficient stature, authority and seniority to effectively influence decisions that affect the level of compliance with AML/CFT requirements.

In view of the critical role of the board of directors, particularly of financial institutions and the larger reporting institutions, in setting the tone and influencing the culture of their institutions, the revised requirements also make the board specifically responsible for maintaining overall accountability for and oversight of the AML/CFT programme within the reporting institution.

(iv) Introduced new requirements on financial group reporting

To ensure that the activities of a financial group do not result in undue risks to the integrity of the financial system, the Bank now requires financial groups to implement AML/CFT compliance programmes on a group-wide basis and to appoint a group compliance officer

² Domestic PEPs are defined as individuals who are or have been entrusted domestically with prominent public functions, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, important political party officials.

for AML/CFT. This will ensure that the AML/CFT compliance programme is consistent across the entire group and facilitate consolidated AML/CFT supervision by the Bank.

(v) Clarified requirements for dealing with customers from higher risk countries

In view of the increasing exposure to cross-border transactions and customers originating from other countries, the Bank enhanced regulatory expectations on financial institutions that transact with persons from countries deemed as higher risk by either the Financial Action Task Force (FATF)³ or the Government of Malaysia. In addition to the CDD, reporting institutions are required to apply counter-measures which are proportionate to the risk posed by these customers or transactions. These measures include reviewing existing relationships with customers or institutions in higher risk countries, and enhancing the intensity and frequency of audits on branches and subsidiaries operating in higher risk countries.

A series of awareness sessions on the revised requirements was conducted for all key sectors and will be continued in 2014 to support the effective implementation of the requirements by reporting institutions as part of their AML/CFT compliance and risk management programmes.

³ FATF is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of weapons of mass destruction. Currently, FATF's membership comprises 34 member countries and two regional bodies.

