

2012

## REGULATORY AND SUPERVISORY FRAMEWORK

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## REGULATORY AND SUPERVISORY FRAMEWORK

The regulatory and supervisory framework in Malaysia is now placed on a substantially stronger footing with the recent enactment of key financial services legislation. The Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA), together with related amendments to the Central Bank of Malaysia Act 2009, provide a new and significantly strengthened foundation on which to build and maintain a regulatory and supervisory framework that is effective, transparent and which contributes to an efficient financial system that is resilient to future stresses. More information on the legal framework for the Malaysian financial sector can be found in the box article 'The Legal Framework for Financial Stability'.

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Malaysia's regulatory and supervisory system received a positive review from the International Monetary Fund and World Bank under the Financial Sector Assessment Program

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The Bank's regulatory priorities continue to be guided by a domestic focus on further raising standards in governance and risk management practices in keeping with the growing scale and sophistication of the activities of financial institutions in and outside Malaysia. A good part of this work included strengthening and updating the prudential rules in line with international regulatory reforms, and in consideration of the more developed financial institutions and their growing presence in the region. At the same time, the regional and international dimensions of regulation and supervision continued to feature prominently in the Bank's work. The Bank has also taken an active role in shaping international regulatory standards, particularly to ensure emerging market perspectives are taken into account, and in further strengthening its relationships with home and host supervisors of financial institutions in Malaysia.

Malaysia's regulatory and supervisory system received a positive review from the International Monetary Fund (IMF) and World Bank under the Financial Sector Assessment Program (FSAP). This involved a full evaluation of the Bank's regulatory and supervisory framework for the banking and insurance sectors against international core principles for effective supervisory systems. The review affirmed the strength and quality of the regulatory and supervisory framework applied in Malaysia, and served to confirm the direction of the Bank's current priorities and initiatives to further strengthen the regulatory and supervisory system. A summary of the assessments and recommendations by the FSAP assessors for banking and insurance supervision is provided in the box articles 'Assessment of Malaysia's Compliance with the Basel Core Principles for Effective Banking Supervision' and 'Assessment of Malaysia's Observance with the IAIS Insurance Core Principles' respectively.

### REGULATORY DEVELOPMENTS AND SUPERVISORY ASSESSMENTS

#### Regulatory capital and liquidity standards

A major step in the domestic implementation of the global regulatory reform package relating to the new capital and liquidity standards under Basel III was taken during the year with the publication of final rules by the Bank in November 2012 that will raise the **level and quality of regulatory capital** that banks must hold. Under the new rules, banking institutions are required to maintain high-quality loss-absorbing capital consisting predominantly of Common Equity Tier 1 (CET1), which comprises paid-up capital, retained earnings and disclosed reserves, at 7% of a banking institution's risk-weighted assets, an increase from 2% previously. The new requirements are being phased in from January 2013 to December 2018 in line with globally determined timelines.

While the rules are broadly consistent with Basel III parameters, the Bank has adopted a more prudent approach in some areas. The Bank views this to be appropriate having regard to domestic market conditions and the desire to preserve the strength and quality of capital buffers, particularly in times of stress. The key areas are: (i) requiring significant

## The Legal Framework for Financial Stability

The enactment of the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA), which were approved by Parliament in December 2012, marks another important milestone in modernising Malaysia's financial sector laws. These new laws are the culmination of more than six years of work which started concurrently with the review of the Central Bank of Malaysia Act 1958, and involved a wide-ranging review of the various laws for the regulation and supervision of the financial sector, particularly taking into account important changes that were occurring across the domestic and global financial landscapes. The review and modernisation of Malaysia's financial sector laws ensure that these laws continue to be relevant and effective in preserving financial stability and supporting the growth of the Malaysian financial system and the real economy.

Over the decade, the focus of and the approach to financial sector regulation and supervision has evolved substantially, not just in Malaysia but also internationally. As the financial system has become more diverse, more sophisticated and more interconnected, financial regulation has correspondingly evolved from detailed and prescriptive rules to a principles-based approach that combines greater supervisory judgment and intensity with high-level principles of sound practice that can be applied to institutions according to the nature, scale and complexity of their activities. There has also been a fundamental re-orientation of the focus of financial supervision to take into account system-wide developments and risks, in addition to the traditional focus on individual financial institutions. This has involved a widening of the scope of oversight to include the supervision of financial groups and non-bank financial institutions that engage in financial intermediation activities. Beyond prudential regulation, the other aspects of financial sector regulation such as business conduct regulation that focuses on consumer protection and financial inclusion have also become more prominent, driven by changing demographics, the increasing complexity of financial products and public policy goals to alleviate poverty, improve equity and enhance growth. Another important feature in the development of Malaysia's financial system has been the growing significance and role of Islamic finance. The development of a comprehensive legislation for Islamic finance has further extended the frontier of financial regulation in Malaysia. These developments have had a significant role in shaping the key statutes which were introduced over the decade and which form part of the legal framework for the financial sector, including the Development Financial Institutions Act 2002 (DFIA), Payment Systems Act 2003 (PSA) and the Malaysia Deposit Insurance Corporation Act 2011 (MDICA). The enactment of the new central bank legislation in 2009, the Central Bank of Malaysia Act 2009 (CBA), and the FSA and IFSA in 2013 capped off the series of comprehensive legislative reforms that have been undertaken.

In the post 9/11 era, global efforts to combat money laundering and terrorism financing have intensified in response to new political realities and increasingly sophisticated money laundering techniques and methods. Preserving the integrity of the financial system and preventing its abuse for criminal and terrorism purposes became an important agenda of the Government. While Malaysia already had in place a rigorous legislation for these purposes in 2001, the scope of reporting institutions under the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA) has now been extended to include non-financial institutions to more effectively address money laundering risks in activities that fall outside the financial sector. The AMLATFA also supports more effective collaboration between the Bank, financial institutions and law enforcement agencies in the areas of crime prevention and national security. Recognising that certain sectors, such as money-changing and remittance services, can be particularly vulnerable to the flow of illicit funds, the Money Services Business Act 2011 (MSBA) and supporting regulatory and supervisory frameworks were put in place to strengthen the Bank's oversight of these sectors.

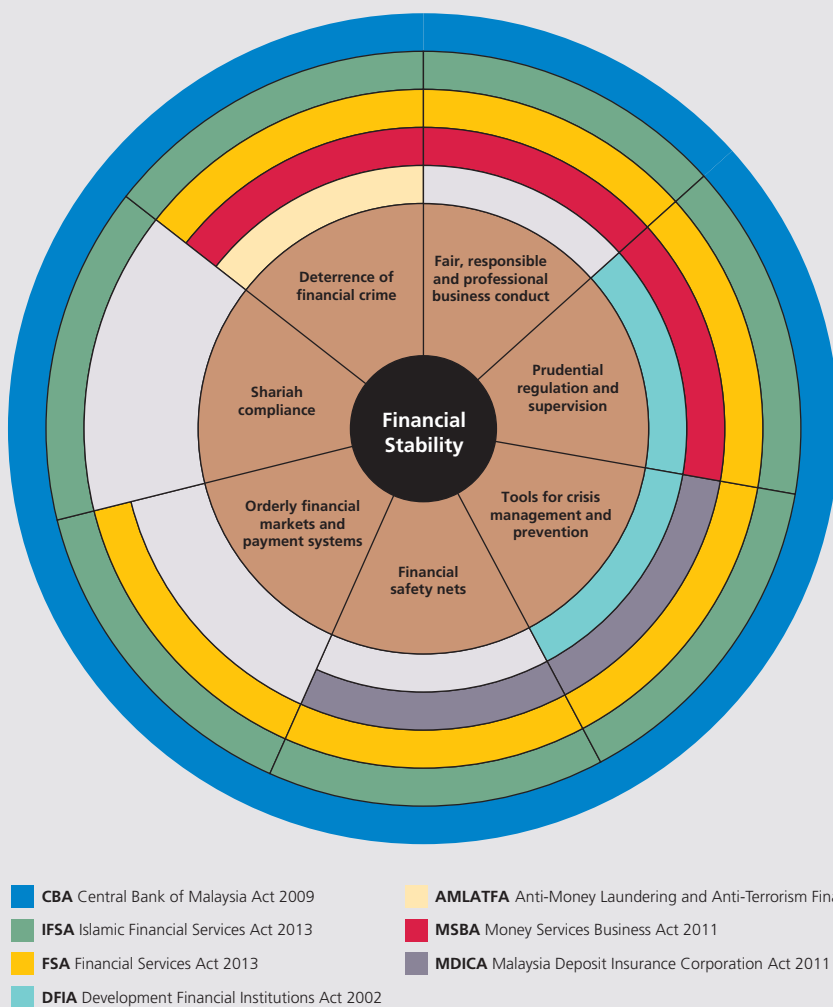
Taken together, the modernisation of Malaysia's financial sector laws serves to promote greater resilience and efficiency of the financial sector and its continued growth, strengthen the regulatory and supervisory environment, provide greater protection for consumers, and preserve a high level of confidence in the financial system. These are supported by enhanced arrangements for inter-agency

collaboration and coordination to better cope with the increasing interconnectedness across industries and national boundaries. The financial sector laws are also intended to keep pace with changes in the financial landscape in a way which will allow financial institutions to tap new opportunities and better manage future challenges, while preserving strong conditions for financial stability. Diagram 1 illustrates the key aspects of a strong regulatory and supervisory system in Malaysia which the statutes address.

The remainder of this article describes the key pieces of legislation that make up the legal framework for the financial sector in Malaysia, including highlights of the main legislative changes that were introduced.

**Diagram 1**

**Comprehensive Laws for Financial Stability**



**Central Bank of Malaysia Act 2009**

A high point of the legislative changes was the enactment of the CBA, coinciding with the Bank’s 50<sup>th</sup> anniversary. The CBA replaced the former Central Bank of Malaysia Act 1958 following a comprehensive two-year review on the role, powers and responsibilities of a modern central bank, providing clarity to the Bank’s mandates on promoting monetary stability and financial stability. With respect to its financial stability mandate, the Bank’s statutory responsibilities are clearly set out in

the CBA, namely to regulate and supervise financial institutions, provide oversight over the money and foreign exchange markets, exercise oversight over payment systems, and to develop a sound, progressive and inclusive financial system. It is upon these responsibilities that the regulatory laws administered by the Bank are founded.

Taking into account a more developed and mature domestic financial sector as well as the challenges presented by the more integrated and globalised economic and financial environment, the CBA vests in the Bank expanded macroprudential powers and instruments to safeguard financial stability. These include wider powers for the Bank to obtain information for purposes of monitoring risks to financial stability and strengthened conditions and powers to take early action to avert and manage crises. It also includes specific powers to resolve systemically-important financial institutions that are not regulated by the Bank, where necessary, to preserve financial stability. In addition, the law enables the Bank to effectively coordinate with other regulatory authorities across sectors and borders, reflecting the greater overlaps in financial services and products offered by different financial institutions, and the wider geographical footprint of financial institutions. These enhanced powers are complemented by a strengthened framework for governance, transparency and accountability for the financial stability mandate. It also includes the establishment of the Financial Stability Executive Committee to provide additional oversight over major financial stability decisions such as the provision of capital support to financial institutions and orders to avert or reduce risk to financial stability for entities not regulated by the Bank.

### **Financial Services Act 2013 and Islamic Financial Services Act 2013**

The FSA and IFSA build upon the foundations of the Bank's financial stability mandate in the CBA and provide the Bank with the necessary powers to effectively perform its regulatory and supervisory roles. They reflect an increased focus by the Bank on early interventions to address emerging problems in financial institutions, and the more risk-focused and integrated approach to the regulation and supervision of financial institutions under the Bank's purview in response to the rapid changes taking place in the financial sector, including the emergence of financial groups that offer a broader range of financial services and products. The FSA and IFSA have respectively combined six pre-existing statutes, namely the Banking and Financial Institutions Act 1989, Insurance Act 1996, PSA and Exchange Control Act 1953 (ECA), and the Islamic Banking Act 1983 and Takaful Act 1984. The new legislation provides a more cohesive and integrated legal framework that delivers a consistent and comprehensive treatment of similar risks, thus minimising the prospect for regulatory arbitrage and gaps, while substantially easing the process of review and update going forward. Key features of the new legislation include:

- Greater transparency and accountability of the Bank in carrying out its principal object to safeguard financial stability;
- Differentiated intensity of regulation and supervision applied to institutions and markets under the Bank's purview, commensurate with the nature of activities and levels of risk posed by such institutions and markets to the overall financial system;
- Transparent assessment criteria for authorising institutions to carry on regulated financial business, and for shareholder suitability;
- New provisions for the oversight of financial holding companies and non-regulated entities to take account of systemic risks that can emerge from the interaction between regulated and unregulated institutions, activities and markets;
- Strengthened business conduct and consumer protection requirements to promote consumer confidence in the use of financial services and products;
- Specific provisions to support the Bank's role in the oversight of the money and foreign exchange markets in cooperation with Securities Commission Malaysia, where relevant;
- Strengthened provisions for effective enforcement and supervisory intervention, including the ability for the Bank to issue directions of compliance or accept legally enforceable undertakings that commit financial institutions to take specific actions to address identified risks, and higher penalties to act as a credible deterrent. The legislation further provides *locus standi* for the Bank to initiate civil actions in court against financial institutions; and

- A clear focus on Shariah compliance and governance in the Islamic financial sector. In particular, the IFSA provides a comprehensive legal framework that is fully consistent with Shariah in all aspects of regulation and supervision, from licensing to the winding-up of an institution.

### **Development Financial Institutions Act 2002**

Six development financial institutions (DFIs) are regulated and supervised by the Bank pursuant to the DFIA to ensure that their development mandates can be achieved in a financially sustainable manner, while contributing to the overall stability of the financial system. The DFIA supports the effective regulation and supervision of DFIs to ensure sound financial management, and strengthens the accountability of DFIs in the performance of their mandated roles. This in turn contributes towards the development of a sound, progressive and inclusive financial sector in Malaysia. As part of the ongoing programme by the Bank to regularly review and update the legal framework for the financial sector, amendments to the DFIA are being proposed to further enhance the regulatory and supervisory framework for DFIs. Proposals will focus on reforms to further improve governance practices within DFIs, strengthen their mandates in filling gaps in the financial system, and promote greater operational efficiencies.

### **Anti-Money Laundering and Anti-Terrorism Financing Act 2001**

The AMLATFA, previously known as the Anti-Money Laundering Act 2001 (AMLA), provides a legal framework to counter the laundering of money from the proceeds of crime, thus preserving the integrity of and confidence in the financial system. Under the AMLA, the Bank was appointed and continues to carry out the functions of the competent authority which include the responsibility to ensure the implementation of reporting obligations by the reporting institutions, and the gathering and dissemination of financial intelligence. In 2003, the Government of Malaysia enacted amendments to five different pieces of legislation, including the AMLA, to enable accession to the International Convention for the Suppression of the Financing of Terrorism. With the coming into force of the Anti-Money Laundering (Amendment) Act 2003 on 6 March 2007, the AMLA was renamed and extended to provide a comprehensive framework of measures for the prevention of money laundering and terrorism financing, and for the forfeiture of terrorist property and property involved in money laundering.

### **Money Services Business Act 2011**

The AMLATFA is also complemented by the MSBA which aims to modernise and elevate the status of the money-changing and remittance businesses into a more dynamic, competitive and professional industry, while strengthening safeguards against the threats of money laundering, terrorist financing and other illegal activities. The MSBA came into effect from 1 December 2011 following the consolidation of the Money-Changing Act 1998 and parts of both the PSA and ECA. Licensed money-changers, approved remittance service providers and approved wholesale currency providers are now regulated and supervised under one law. Under the MSBA, the Bank's surveillance capabilities and powers of examination and investigation have been further strengthened. At the same time, broader enforcement powers, including administrative penalties and civil actions, have further enhanced the Bank's ability to effectively address weaknesses in the industry that could give rise to the risk of abuse for money laundering and financial crimes.

### **Malaysia Deposit Insurance Corporation Act 2011**

The Malaysia Deposit Insurance Corporation Act 2005 established the deposit insurance system in Malaysia to protect deposits placed with licensed commercial and Islamic banking institutions. This law also established the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) to administer the deposit insurance system, provide strong incentives for sound risk management through differential deposit insurance premiums and act as a resolution agency. In 2011,

the law was replaced by the MDICA. Key changes that were made to provide for a wider financial safety net also include a takaful and insurance benefit protection system and powers for the Minister to extend insurance or protection coverage beyond the scope of the normal protection for deposits as well as takaful and insurance benefits, for purposes of protecting the stability of the financial system. This legislation complements the Bank's regulatory laws, in promoting sound risk management in financial institutions and maintaining public confidence in the financial system, particularly during times of financial stress.

investments in capital instruments of insurance, takaful and other financial entities to be fully deducted from CET1 to more effectively address double-leveraging and to provide a stronger defence against contagion risk within financial groups; (ii) limiting the recognition of unrealised fair value gains of financial instruments in view of the uncertainty in the valuation of certain instruments, especially instruments which are not actively traded or during times when the market for such instruments is illiquid; (iii) strengthening loss-absorbing requirements for Additional Tier 1 and Tier 2 capital instruments; and (iv) requiring capital instruments issued by Islamic banks to be structured in a manner that adheres to established Shariah principles based on the contract used.

A concern raised by the industry has been with the potential for competitive distortions created from an uneven implementation of the Basel III standards in the international financial system, either in timing or detail. On this, the Bank has carefully considered the strong starting positions of the Malaysian banking institutions to meet the higher standards and the generous transition period (which the Bank has elected to follow without acceleration in most areas) which will allow for a gradual build-up of the required buffers. The Bank also holds the view that like-for-like comparisons are likely to be difficult across countries given the different approaches taken by national authorities where either more conservative or concessionary approaches have been reflected in different ways in the domestic rules. For example, some authorities have elected for specific reasons to specify higher minimum levels of regulatory capital while others have adopted more conservative treatments in specific areas. Authorities also have some scope to apply the discretion provided under Basel III to specify a different treatment for the calculation of regulatory capital in respect of particular exposures. These differences considerably complicate the international comparability of reported regulatory capital ratios.

The more important consideration in Malaysia has been the potential implications, and in particular, unintended consequences, of the reforms for domestic intermediation activities. The Bank's assessment, based on detailed capital calculations and growth projections provided by banking institutions under the new rules, is that the Malaysian banking sector is well placed to meet the strengthened capital requirements as defined

by the Bank with the impact on the costs and functioning of domestic financial intermediation likely to be minimal (the CET1 capital ratio of the Malaysian banking industry, computed based on the Basel III standard, stood at more than 12% at end-2012, well above the 3.5% minimum that comes into effect in 2013). In contrast, the benefits of the stronger capital buffers, as implied by the results of stress tests under extreme but plausible adverse scenarios, are significant in terms of reducing the probability and costs of bank failures and disruptions in financial intermediation. The benefits are greater in an environment of greater uncertainty and volatility, and with the increased interdependencies and inter-linkages of the financial system.

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The Malaysian banking sector is well placed to meet the strengthened capital requirements under Basel III, with the impact on the costs and functioning of domestic financial intermediation likely to be minimal

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In June 2012, the Bank also began an observation period during which the leverage and liquidity positions are reported by banking institutions using Basel III parameters. This is intended to enable the Bank to monitor the implications of the Leverage Ratio and liquidity standards which represent the other major components of the Basel III reform package, and to appropriately calibrate policy measures to ensure the smooth implementation of the standards. As a result of this reporting exercise, banking institutions have started to take steps to improve the quality of information captured in relation to the behaviours of their depositors, in particular wholesale depositors with operational relationships with the banking institution, in order to determine their regulatory treatment for purposes of meeting the liquidity standards.

Based on early results from the observation period, the strong capital position of the banking system is likely to ease the implementation of the **Leverage Ratio** in 2018. However, it remains too early to obtain a clear assessment on the

potential for a binding leverage standard to induce a shift by banking institutions in favour of higher-risk activities over lower-risk but productive economic activities such as trade financing. One reason for this is that leverage levels in the banking system are at substantially more prudent levels than the minimum contemplated under Basel III, thus allowing some room for computational adjustments in accordance with Basel III rules to take effect without materially affecting current business directions. The banking system leverage position currently stands at more than 6% under Basel III rules, well above the minimum of 3%. It should also be noted that as part of the Bank's supervisory and macro-surveillance activities, leverage has been and continues to be a key metric that is already monitored by the Bank to identify the potential build-up of excessive risks in the financial system. This has contributed to keeping leverage levels from increasing beyond what would be regarded as prudent. Nevertheless, the potential impact of a binding leverage standard on the ability of banks to continue supporting productive economic activity remains a concern that will be closely monitored by the Bank in the implementation of the Leverage Ratio in Malaysia.

The expected challenges that banking institutions would face in complying with the **Liquidity Coverage Ratio (LCR)** (based on the original parameters set by the Basel Committee on Banking Supervision in December 2010) were confirmed in the early reports from the observation period. The LCR promotes a bank's short-term resilience to liquidity shocks by requiring banks to hold adequate liquidity buffers to survive a 30-day period under a liquidity stress scenario. Challenges faced by banking institutions in complying with the LCR were largely due to the significance of wholesale deposits as a source of funding for the Malaysian banking sector. Such deposits account for more than 60% of total deposits of the banking system.

Compliance levels should improve with recent changes made to the LCR standard by the Basel Committee in January 2013. These changes address some of Malaysia's concerns with the implementation of the liquidity standards in three important ways. The first relates to the severe assumptions on withdrawals (or 'run-off' rates) that were initially applied to corporate deposits. This has now been adjusted to provide lower run-off rates for corporate deposits. While not directly addressed in the revised rules, the Bank will continue to consider suitable options for

the treatment of deposits placed by institutional savings schemes in Malaysia, and in particular the Employees Provident Fund, which have an important role in channelling stable funding from households to the banking sector.

A second concern was the potential impact on market liquidity conditions due to the restrictive pool of eligible liquid assets recognised under the liquidity standard. Under the revised rules, the range of high-quality liquid assets (HQLA) which can count towards compliance with the LCR has been expanded, notably to include lower-rated corporate debt securities, unencumbered equities and residential mortgage-backed securities, subject to appropriate valuation discounts and prudential limits. The third area relates to the structural constraints faced by Islamic banks due to the lack of Shariah-compliant instruments available in the market to meet the LCR. The revised rules have included an additional option for national supervisors to develop alternative liquid asset frameworks for application to Islamic banks only. The option provides explicit national discretion for supervisors to define Shariah-compliant financial products as alternative HQLA for Islamic banks, subject to conditions and valuation discounts that the supervisor may require.

The Bank welcomes these changes which better reflect realistic market behaviours and funding conditions in Malaysia. In addition, a longer phase-in period extending to 2019 (from 2015 originally) for full compliance with the standard has also been provided under a revised timetable announced by the Basel Committee. This should further help to achieve a smooth transition to the new LCR standard in Malaysia. Further insights from the observation period will be important to obtain a more complete picture of the likely market implications and behavioural adjustments of banks in response to the liquidity standard. This will also inform the Bank's approach to the implementation of the LCR which will be outlined for consultation with the industry in early 2014, and the Net Stable Funding Ratio thereafter. Meanwhile, the Bank will continue to actively engage the international standard setting community to provide a perspective on the implications of the new standards for emerging markets through its participation in international and regional groupings of central banks and supervisors.

As part of the Bank's efforts to promote more effective **management of liquidity risk among development financial institutions (DFIs)**, the

Guidelines on Liquidity Management Framework for Development Financial Institutions which was previously applicable only to Bank Kerjasama Rakyat Malaysia Berhad (Bank Rakyat) and Bank Simpanan Nasional was extended to include the three remaining deposit-taking DFIs, namely Bank Pertanian Malaysia Berhad (Agrobank), Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank) and Bank Pembangunan Malaysia Berhad in May 2012. The Guidelines, which are substantially similar to the current Liquidity Framework applicable to banks, seek to ensure that DFIs maintain sufficient high-quality liquid resources to meet unexpected deposit withdrawals, both in the ordinary course of business and in times of stress. Similar to the Liquidity Framework for banking institutions, it also aims to limit funding concentrations.

In the takaful sector, a major component of regulatory reforms to strengthen the prudential framework for takaful operators was completed during the year with the issuance of the final **Risk-Based Capital Framework for Takaful Operators (RBCT)** in October 2012 following extensive industry consultations and quantitative impact assessments. The RBCT is similar in concept to the Risk-Based Capital Framework for Insurers in that it provides for capital assessments on a total balance sheet approach. This approach is more sensitive to the risk profiles of individual takaful operators compared to the existing simplistic solvency regime. However, the RBCT has important differences that reflect the business models which are unique to takaful operators and the specificities of Islamic contracts that takaful operators enter into.

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A major component of regulatory reforms to strengthen the prudential framework for takaful operators was completed with the issuance of the final Risk-Based Capital Framework for Takaful Operators in October 2012

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A number of refinements were made to the RBCT in consideration of the feedback received from the industry during the consultation

process and results from the quantitative impact assessments conducted by the Bank. This included amendments to provide for the wider recognition of capital resources in the capital adequacy ratio used to meet the Supervisory Target Capital Level. The capital charges for contribution liabilities and expense liabilities were also recalibrated, having considered recent improvements in provisioning practices by the industry.

The RBCT will be fully implemented as a binding requirement on takaful operators beginning 1 January 2014, following a further one-year parallel run period for takaful operators to enhance their operations and systems in preparation for full implementation.

The rules-based prescriptions on regulatory capital which apply to banks and insurers/takaful operators (under Pillar 1) are supplemented by a rigorous process of supervisory reviews of an individual institution's capital management practices under Pillar 2 which require institutions to assess and hold sufficient capital relative to its risk profile, including risks which are not covered or fully captured under Pillar 1. In this regard, banking institutions are expected to comply with Guidelines on the **Internal Capital Adequacy Assessment Process (ICAAP)** issued by the Bank from January 2013. Since the issuance of the Guidelines in 2010, banking institutions have demonstrated good progress in strengthening the fundamental building blocks of the ICAAP, including in particular the establishment of a formal risk appetite framework and enhancements to information technology (IT) and data systems to support the identification and measurement of risks at more granular levels. Comprehensive on-site supervisory reviews of the ICAAP of banking institutions will be undertaken by the Bank in 2013.

Banking institutions also continue to further refine their methodologies for measuring material risks and for allocating capital under Pillar 2. One area in which considerable divergence in practice continues to be observed is the measurement of, and correspondingly, capital allocated to, **interest rate risk in the banking book (IRRBB)/rate of return risk in the banking book (RORBB)**. This reflects the different modelling approaches adopted by banks in the treatment of the material drivers of IRRBB/RORBB. Given the significance of IRRBB/RORBB to bank exposures, it is important to ensure that institutional modelling practices are

well supported by sufficiently prudent assumptions and effective oversight arrangements. With this in view, the Bank has initiated work to enhance the existing regulatory reporting requirements for IRRBB/RORBB to support more detailed supervisory assessments. This will also enable the Bank to determine the need for more specific industry guidance to provide greater clarity around supervisory expectations on the treatment of IRRBB/RORBB.

In the insurance industry, the corresponding **Guidelines on ICAAP for Insurers** were finalised by the Bank in March 2012 and became effective on 1 September 2012. Progress towards putting in place systematic approaches to the ICAAP has been more even across the industry with the issuance of formal guidance by the Bank. A number of insurers have strengthened internal oversight arrangements for capital planning and management, and formalised processes for measuring the impact of business strategies on the insurer's solvency position to support the implementation of the ICAAP. The Bank continues to engage individual insurers on specific aspects of the implementation of the Guidelines where gaps remain. This includes the proper reflection of the overall risk appetite of an insurer in operational limits set for business units, more robust assessments and reporting of risk exposures and improvements to stress testing approaches for significant risks. Takaful operators will similarly be required to set appropriate individual target capital levels with the implementation of the RBCT from January 2014.

### **Risk management and prudential requirements**

In 2012, the Bank stated its intention to develop requirements on effective **risk governance** to be observed by all financial institutions. This work was completed with the issuance of the Guidelines on Risk Governance for banking institutions, insurance companies, takaful operators and DFIs in March 2013 following two rounds of industry consultation. The Guidelines clarify the board's role in setting and controlling a financial institution's risk appetite and risk strategy, and require financial institutions to establish independent and suitably competent risk management functions with clear roles and mandates, an appropriate stature within the organisation and with direct access to the board and senior management. The Guidelines also address expectations for institutions to ensure that incentive and remuneration systems

are aligned with prudent risk taking. While many institutions are already practising much of what is required under the Guidelines, some institutions will need to undertake more fundamental reviews of existing organisational arrangements and practices to comply with the Guidelines. Most institutions also indicated the need to continuously improve the technical skills and knowledge among risk management professionals, and address limitations in current risk management systems to support effective risk management on an enterprise- and group-wide basis as their activities increase in scale and complexity. Overall, significant investments were made in strengthening risk management infrastructures in the banking sector over the last decade and more substantial changes are expected to come from institutions in the insurance, takaful and DFI sectors. An important expected outcome of the Guidelines is the strengthening of preconditions for effective risk management on a group-wide basis for some of Malaysia's largest financial groups which have material operations in more than one regulated sector within the financial industry, or significant overseas operations.

Related to efforts by the Bank to strengthen risk governance practices in financial institutions was an exercise undertaken by the Bank to review the existing **prudential requirements applicable to Appointed Actuaries**. A key objective of the review was to strengthen the effectiveness of the actuarial function in general, and the Appointed Actuary in particular, in supporting an insurer's or takaful operator's management of insurance/takaful and financial risks. The Bank's proposed enhancements to existing Guidelines on the Appointed Actuary are expected to be released for consultation in April 2013. Among others, the proposals limit the Appointed Actuary's involvement in the pricing of insurance/takaful products. The proposals also set out requirements to support more effective communications of key issues and concerns by the Appointed Actuary to the board and management, and greater expectations for the board to have a good understanding of important actuarial issues and how these bear on an insurer or takaful operator's risk appetite and business strategy. The Bank also proposes to extend the Guidelines, which were previously applicable only to life insurers and family takaful operators, to general insurers and takaful operators. This will entail the formal appointment of Appointed Actuaries in general insurers and takaful operators

to undertake specific functions in ensuring an institution's sound and prudent management of its insurance/takaful business, including the preparation of financial condition reports for the board.

With competition becoming increasingly intense in the market for retail loans and financing, the Bank maintained a close oversight on developments in **credit risk management practices** in the banking industry. Although credit discipline has generally remained intact, some banking institutions were observed to price retail loans at more aggressive levels than might be implied by realistic assumptions of expected credit losses. The Bank's supervisory activities remained alert to systematic weaknesses in pricing policies which can distort capital allocations and potentially increase losses incurred by banking institutions in the event of loan defaults. For the most part, more aggressive pricing practices have been supported by stringent lending criteria. However, the wider adoption of risk-informed pricing practices across the industry continues to be challenged by data and system limitations – a priority that the Bank expects banking institutions to address to be firmly in step with credit growth in the retail segment. Pending the resolution of implementation issues of the proposed Guidelines on Risk-Informed Pricing for Retail Loans/Financing, individual banking institutions have been encouraged to adopt sound pricing practices based on the principles advocated under the Guidelines. Further engagements will be carried out to assist banking institutions to overcome remaining implementation challenges, particularly on issues that relate to data limitations and systems constraints, which will be essential to elevate the standards of credit risk management in this segment. The Bank expects that the Guidelines will be finalised in the second half of 2013.

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## The strengthened rules for managing exposures to single counterparties came into effect on 1 March 2013

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In February 2012, the Bank outlined its detailed proposals for strengthening the **prudential framework for managing exposures to single counterparties**. The proposals seek to contain risk concentrations in a more interconnected

environment by expanding the scope of exposures subjected to the prudential limits, and training the focus of banking institutions on risk correlations that can arise from economic dependence between connected counterparties. Submissions from the industry mainly centred on the operational challenges of monitoring compliance with the limits and the need for suitable transitioning arrangements to address the immediate impact of the proposals on certain aspects of banking institutions' operations. Taking these into consideration, the Bank refined the requirements in a number of key areas. This included the incorporation of criteria based on considerations of materiality and ease of substitution to be applied for the purpose of aggregating exposures to connected counterparties. Exclusions for interbank exposures in the domestic interbank money market from the limits have been preserved under the new rules to facilitate liquidity management activities, although this will continue to be reviewed by the Bank as international standards on large exposures begin to take shape. Transitioning arrangements have also been clarified, both for existing exposures and for phasing in the more comprehensive requirements under the new rules. The finalised rules came into effect on 1 March 2013.

Work on the sixth pillar of the risk management framework applied to the financial industry was largely completed during the year with the development of the Guidelines on **Operational Risk Management** which will be published for consultation in the first half of 2013. The other pillars consist of the Guidelines on Risk Governance, which are supplemented by more specific guidelines on the management of credit risk, market risk, liquidity risk and insurance risk. The concept paper outlines key principles of sound operational risk management, based on a comprehensive review of domestic practices, and guidance drawn from international standards as well as leading operational risk management practices. It also sets out to specifically address some of the root causes of the more recent experiences of significant operational risk failures experienced among leading global financial institutions despite the appearance of reasonably effective risk management controls practised by these institutions. A key thrust of the Guidelines is the emphasis on cultivating an environment within financial institutions which makes operational risk management a shared responsibility at all levels of the institution, supported by platforms for the deliberation of operational risk matters; clear and

appropriate operational risk tolerance limits; and effective processes for monitoring operational risk and exposures to losses.

One aspect of operational risk that must continue to be rigorously managed by banking institutions is the risk of security threats in the online banking space which can affect broader confidence in electronic banking facilities. This is to avoid attempts by fraudsters to intercept access by individuals to their accounts through online channels. While incidents of actual losses to banking institutions have been low, the Bank has required banking institutions to implement strengthened safeguards – including enhancements to existing infrastructure and improved processes for monitoring and detecting security threats – to better protect their Internet banking systems. The Bank also extended the application of the Guidelines on Data Management and Management Information System (MIS) Framework to DFIs in November 2012 to strengthen the internal data management capabilities within DFIs to support sound business judgments and effective risk management.

The increasing complexity, interconnectedness and span of cross-border operations of financial groups in recent years have raised the need for more effective **oversight over financial groups** to ensure that the groups' activities do not pose undue risks to the safety and soundness of regulated financial institutions, and by extension, the stability of the financial system as a whole. The monitoring and supervision of group-wide risks has long been an important element of the Bank's supervisory oversight. The Bank's primary concern is with the risks to regulated institutions that can arise from an institution's interaction and association with the wider group to which the institution belongs. However, until now, important elements of the legal framework were insufficient to enable the Bank to apply and enforce appropriate prudential standards on the holding companies of regulated institutions to promote the financial and operational soundness of the group as a whole. This gap is closed by the FSA and IFSA which provide the Bank with explicit powers to specify prudential standards for financial holding companies, conduct ongoing supervision on a consolidated basis, and require corrective actions by financial holding companies to address identified risks to regulated institutions.

With the enactment of the new legislation, the Bank aims in the second half of 2013 to publish initial proposals on the scope of consolidated

supervision that will be applied on financial groups; the limitations on non-financial activities that can be undertaken by approved financial holding companies; and key prudential standards on capital, liquidity, corporate governance and risk management that financial holding companies will be required to observe. This will also entail the strengthening of prudential requirements concerning intra-group transactions and exposures, which will include a review of the existing Guidelines on Credit Transactions and Exposures with Connected Parties applicable to banking institutions. The implementation of the prudential standards is expected to be gradually phased in from 2014, with the timeline for financial requirements to be determined after a further consultative process with affected financial groups and planned impact assessments.

## SAFEGUARDING THE INTEGRITY OF THE FINANCIAL SYSTEM

An important responsibility of the Bank is to safeguard the integrity of the financial system by requiring regulated businesses to have in place effective controls to counter the risk of being used for illegal activities and the monitoring of their implementation. This is also complemented with enforcement actions against the unauthorised conduct of business which is regulated under the banking, insurance and money services legislation.

The Bank's supervision and enforcement activities in this respect were intensified in 2012. A large part of this work involved the reassessment and confirmation of licences issued to entities in the **money services business industry**, comprising money changing, remittance services and wholesale currency businesses, as part of the transition to a strengthened regulatory regime under the Money Services Business Act 2011. The main objective of the re-licensing exercise is to strengthen the industry's defences against the risk of abuse for illegal purposes by ensuring that only entities that are controlled and managed by persons of integrity, and that are able and willing to comply with regulatory requirements, are granted licences to operate money services business. A secondary objective is to raise the standards of professional conduct and the image of the industry. In ensuring a smooth transition to the new regime, the Bank closely engaged the industry and sought to ensure that the exercise

was conducted in a manner without affecting access by the public to money services.

The re-licensing process, which was completed in December 2012, achieved the following outcomes:

- More than 100 entities that failed to demonstrate basic record keeping and compliance systems which are essential to detect and prevent illicit activities, or where persons in control had failed to meet fit and proper requirements, were required to cease operations;
- The financial and operational capacity of entities was strengthened, enhancing the ability of these entities to implement effective controls against risks associated with financial crime. This resulted from a combination of the higher capital commitments to the entities as required under the new legislation, mergers between smaller entities, and the opportunity for entities that opt to become agents to leverage on the systems and controls provided by larger and more established money service providers;
- More than 190 additional access points were provided for the public to conduct remittance transactions as a result of the approval of qualified money changers as remittance agents for licensed remittance service providers. The increased access is expected to facilitate the migration of remittances, especially by foreign workers, from informal to formal channels;
- A greater number of well-managed licensees were authorised to conduct wholesale currency business (importing and exporting foreign currency for supply to local money changers) in different parts of Malaysia. This is expected to address the difficulties that had been faced by money changers in clearing and sourcing currency stocks, leading to a reliance on transactions with individuals carrying foreign currencies across borders into Malaysia, for which the sources of funds may not have been properly verified; and
- Three new global money services business operators were admitted to the industry with the potential to significantly raise the standards of controls against money laundering and other illegal activities across the industry through their appointment of a wide network of local money changers as agents. The companies will have a direct role in implementing effective systems and controls on their agents. In addition, they are

expected to contribute to industry training and other development initiatives to raise the overall level of professionalism and image of the industry.

In total, the number of entities in the money services business industry fell sharply to 515 from 839 in December 2011, following the re-licensing initiative. The entities that obtained licences under the new Act are generally better positioned to provide professional services and to meet regulatory expectations for stronger defences against financial crime. Notwithstanding this, a good number of these entities will be required to significantly improve existing processes and controls for addressing money laundering risks over the next six to twelve months. Weaknesses found in the operations of money services business include a high tolerance for risk in facilitating transactions for which sources of funds are suspicious or unknown, the inconsistent conduct of minimum customer due diligence procedures, and the lack of an effective programme for building competencies to monitor, handle and report suspicious transactions. Enforcement actions have been or are being taken against more than 170 entities in relation to these failures to comply with regulatory requirements, ranging from monetary compounds to the rejection of key responsible persons or the revocation of licences for the more serious offences. Corrective and remedial actions by money services businesses will be closely monitored by the Bank. On a positive note, the Bank has also observed significant improvements in record keeping across the industry and a better understanding of regulatory requirements as a result of the Bank's on-site visits and a sustained programme of industry engagements and briefings implemented by the Bank throughout the year.

During the year, the Bank also provided detailed guidance to facilitate compliance by entities in the industry with legal and regulatory requirements. This covered reporting obligations and specific requirements on minimum oversight as well as operational and control arrangements that promote effective safeguards against illicit activities and ensure adequate protection for customer transactions.

At the broader system level, the Bank continued to take a central role in driving **anti-money laundering/counter financing of terrorism**

**(AML/CFT) initiatives** at the national level in collaboration with other law enforcement agencies. The national framework for combating financial crimes in Malaysia is supported by the National Coordination Committee to Counter Money Laundering (NCC). The Committee is chaired by the Bank and serves to coordinate inter-agency initiatives and facilitate the exchange of information among 16 Ministries and Government agencies involved in combating financial crimes. The institutional structure of the NCC was enhanced in 2012 to allow for greater focus and better oversight by the Committee of strategic priorities to combat financial crime. This saw the formation of a working level committee to provide more effective operational support for the implementation of AML/CFT measures by agencies and Ministries under the NCC.

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The institutional structure of the National Coordination Committee to Counter Money Laundering was enhanced in 2012 to allow for greater focus and better oversight by the Committee of its strategic priorities to combat financial crime

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The legal framework for combating money laundering and countering the financing of terrorist activities was also further strengthened in 2012 with the expansion of predicate offences under the Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA) to include the financing of activities which contribute to the proliferation of weapons of mass destruction under the Strategic Trade Act 2010, money laundering activities arising from human trafficking under the Anti-Trafficking in Persons and Anti-Smuggling of Migrants Act 2007, direct selling and pyramid scheme activities under the Direct Sales and Anti-Pyramid Scheme Act 1993, as well as offences under the Companies Act 1965, Control of Supplies Act 1961 and Control of Supplies Regulations 1974.

During the year, financial institutions were required by the Bank to conduct self-assessments on the level of money laundering and terrorist financing risks faced in their operations and

to identify compliance gaps. The results of the self-assessments suggest a heightened level of awareness and understanding, particularly by boards of directors, of AML/CFT compliance issues and financial crime risks. Financial institutions also reported continued efforts to improve the overall effectiveness of their compliance programmes, particularly in relation to the management of customer due diligence and ongoing monitoring of suspicious transaction patterns. This has been supported by a larger pool of AML/CFT specialists within financial institutions. Collectively, these efforts have contributed not only to a steady increase in the number of suspicious transaction reports (STRs) reported by financial institutions to the Bank over the past several years, but also in their quality for further analysis and investigation.

The collective enforcement capacity of law enforcement agencies also increased in 2012, with a higher number of AMLATFA accredited investigation officers and the establishment of dedicated AML/CFT units within all law enforcement agencies with expanded resources to better coordinate and undertake investigations and prosecutions on money laundering and terrorist financing. In 2012, the number of money laundering and terrorist financing investigations initiated by the police and other agencies correspondingly increased. Between 2008 to 2011, 73 offenders were brought to court for money laundering offences, on account of 4,371 charges involving about RM2 billion, with 27 convictions obtained.

Malaysia's efforts to strengthen the legislation and implementation of AML/CFT measures have been recognised by the IMF and the World Bank during the recent FSAP when Malaysia was accorded a 'Compliant' rating for the Basel Core Principles (BCP 18) and 'Observed' for the Insurance Core Principles (ICP 22) relating to AML/CFT. Moving forward, the Malaysian AML/CFT regime will be undergoing its third round of the Mutual Evaluation Exercise by the Asia/Pacific Group on Money Laundering in 2014. In preparation for this, multi-agency working groups have been established under the NCC to review the existing AML/CFT framework to ensure it remains relevant and effective, and to take into account the Revised International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation issued by the Financial Action Task Force in February 2012.

## SUPERVISORY CAPACITY AND COOPERATION

To ensure effective oversight over the financial system as regional and international linkages continue to expand, the Bank further strengthened its cooperation arrangements with other central banks and supervisory authorities. Supervisory colleges continued to be a key platform for exchanging information and coordinating supervisory activities involving cross-border financial groups. This enables the Bank to assess, and where appropriate, take measures to mitigate, the potential for the international operations of financial institutions to amplify the cross-border transmission of risks. During the year, the Bank hosted supervisory college meetings for two regionally-active Malaysian financial groups, and participated in supervisory college meetings involving five foreign financial institutions with operations in Malaysia. In addition to deliberations on key risks and developments affecting the financial groups in question, discussions also centred on the impact of implementing various national and global regulatory reform initiatives on the business and operations of these groups.

More recently, national authorities have started to focus on strengthening the framework for resolving systemically-important, internationally active financial groups. This follows the call of the Financial Stability Board to establish crisis management groups for all global systemically-important financial institutions with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting significant financial groups. The Bank continues to support these initiatives through its participation in regional discussions on crisis management. While these initiatives are still at an early stage and various implementation challenges – such as that concerning differences in national resolution and insolvency regimes, and the sharing of sensitive information – remain at the fore, efforts to build a comprehensive and robust resolution regime are gaining traction at the global level. On the regional front, the Executives' Meeting of East Asia Pacific Central Banks has an instrumental role in supporting national-level efforts to strengthen resolution frameworks, as well as in developing a regional framework for timely, effective and cohesive responses to various crisis scenarios, which include the failure of regionally-active financial groups.

Domestic arrangements for cooperation between the Bank and other authorities which contribute to financial stability also continued to be strengthened. These arrangements allow the Bank to obtain a more complete view of potential risks to financial stability, including risks associated with financial intermediation activities carried out by non-bank financial institutions and the operations of systemically-important payment and settlement systems. They also serve to give clarity to the way in which the Bank will coordinate with other authorities in areas of surveillance, regulation, supervision and enforcement where the Bank shares oversight responsibilities with another authority.

Under the FSA and IFSA, the Bank has specific obligations to cooperate with relevant authorities in the oversight of the money market; on issues falling under the purview of the competition authority; and in regulating the deposit-taking activities of co-operatives from persons that are not members of the co-operatives. To operationalise such obligations, the Bank signed an enhanced memorandum of understanding (MoU) with Securities Commission Malaysia in October which significantly expands the scope of cooperation between the Bank and the Securities Commission in line with the expanded roles and mandates of both agencies. The MoU provides for more effective supervision of financial groups by the Bank, closer cooperation in the oversight of conduct issues in relation to banking activities in the capital market, and strengthened protocols for the exchange of information for purposes of monitoring systemic risks in the capital market and the broader financial system. It also provides arrangements for the cooperation and exchange of information between the Bank and the Audit Oversight Board established under the Securities Commission, on issues relating to the quality of external audits of financial institutions. Similar arrangements for cooperation with the Malaysia Competition Commission and Malaysia Co-operative Societies Commission are being developed.

The Bank also continued to cooperate closely with the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM) under the new Strategic Alliance Agreement (SAA) between the Bank and PIDM which was signed in April 2012. The SAA clarifies, among others, the roles and responsibilities of PIDM and the Bank in the process of resolving financial institutions that are member institutions.

This is now reflected in the FSA and IFSA and will contribute to improving the 'legal and procedural clarity for orderly resolutions' as promoted by the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.

In ensuring that the supervisory regime remains effective and responsive to the more dynamic conditions in which financial institutions operate, the Bank has continued to invest heavily in strengthening its supervisory capacity and resources. Advanced supervisory skills training consumed a significant portion of the Bank's training budget in 2012, reflecting efforts to solidify the Bank's core of frontline supervisors. A continuing challenge for the Bank has been its ability to retain a deep pool of staff with extensive supervisory and industry experience needed to support the Bank's supervisory and policy-making functions. While the average supervisory or relevant industry experience of supervisory staff in the Bank has remained relatively stable at above seven years for core supervisory staff, the attrition of supervisory staff will continue to be a risk that needs to be managed by the Bank. Over the years, the Bank has continued to improve its approaches to staff development and profiling to accelerate the time-to-competence for new hires, and building strong leadership competencies among senior supervisors who will be able to effectively develop direct reports under them. In addition, the Bank's pool of specialists has been expanded to include accounting and Shariah specialists to complement the work of frontline supervisors. These initiatives have helped to preserve the high quality of staff in supervisory roles who ensure that the Bank's risk-based approach to supervision continues to be effective.

During the year, the Bank also invested in upgrading its internal supervisory IT systems to improve the efficiency of the Bank's supervisory processes. The enhanced infrastructure includes the development of an electronic supervisory dashboard that facilitates continuous monitoring and surveillance of financial institutions, and a centralised system for document management which will further improve the quality and consistency of the documentation of the Bank's supervisory assessments. It has also

substantially increased the efficiency of internal reviews of supervisory assessments by improving information flows across supervisory teams.

A major undertaking to merge the Financial Intelligence and Special Investigation Units of the Bank was completed in 2012, to form a new Financial Intelligence and Enforcement Department. The department will be responsible for formulating AML/CFT policies and strategies, carrying out investigation, surveillance and intelligence activities while acting as the central agency to disseminate financial intelligence to relevant law enforcement agencies for investigations. Under the new structure, all investigation and enforcement activities across the Bank will be consolidated under one department. This provides a clearer accountability and governance structure for enforcement actions by the Bank, while enabling the Bank to capture important synergies and leverage common skill sets within these functions.

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In ensuring that the supervisory regime remains effective and responsive to the more dynamic conditions in which financial institutions operate, the Bank has continued to invest heavily in strengthening its supervisory capacity and resources

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The initiatives elaborated above largely complete plans laid out by the Bank in 2011 to enhance its supervisory resources, processes and tools which had five key thrusts: (i) further strengthen its stress testing capabilities (see Chapter 1); (ii) improve the allocation and optimal use of the Bank's supervisory resources; (iii) increase automation and better integrate surveillance systems; (iv) implement an improved framework for the supervision of consumer conduct issues (see Chapter 4); and (v) strengthen the oversight of enforcement activities.

## Assessment of Malaysia's Compliance with the Basel Core Principles for Effective Banking Supervision

Malaysia demonstrated a high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs) as assessed by the International Monetary Fund (IMF) and the World Bank under the Financial Sector Assessment Program (FSAP). The 25 BCPs represent an international standard of high-level principles against which a country's regulatory and supervisory system is benchmarked and assessed. The BCPs are elaborated through more detailed 'essential' and 'additional' criteria that guide a compliance assessment. Malaysia was assessed to be either 'compliant' or 'largely compliant' against all 25 BCPs (Table 1).

The IMF has acknowledged that the new financial services legislation – the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) – together with enhancements to existing regulatory standards and processes that were already well in progress at the time of the assessment would address almost all of the recommendations for improvements. Issues identified under six BCPs, which are currently rated largely compliant, will be resolved with the improvements that have already been made.

This article presents a summary of the assessment and key observations of Malaysia's compliance with the BCPs. The detailed assessment is published separately on both the IMF's and the World Bank's websites.

The key findings from the assessment are:

- **Regulatory and supervisory functions are well supported by a comprehensive legal framework that clearly defines the objective of the Bank, sound institutional arrangements and adequate resources.** The legal framework enables the Bank to authorise the establishment of banking institutions, issue a wide range of prudential regulations, access and obtain information, take the necessary supervisory actions and provide legal protection for staff acting in good faith when pursuing their duties. A high level of operational independence is accorded to, and demonstrated by, the Bank in determining its regulatory and supervisory focus and allocation of resources to carry out its functions. These functions are staffed with qualified and competent personnel with a high degree of professionalism and integrity.
- **Entry into the industry via new licences and the acquisition of significant shareholding is subject to rigorous review.** A comprehensive and robust assessment process exists to ensure that any new entry into the banking market is subject to prudential standards.
- **A comprehensive compendium of prudential requirements and guidance is in place, aimed at promoting safety and soundness, market discipline and integrity of the financial system.** The capital adequacy framework is consistent with international standards and effectively implemented. This will be further enhanced with the implementation of the Basel III reform package beginning 2013. Prudential standards on risk management provide a sound basis for the effective supervision and assessment of the quality of risk management in banking institutions. The liquidity framework ensures sufficient liquidity buffers under both normal and stress conditions, while requiring funding sources to be adequately diversified. Requirements, including prudent provisioning practices, are also in place for dealing with problematic assets and are effectively reviewed by supervisors. The implementation of corporate governance standards and guidelines on internal controls, together with a strong regulatory focus on directors' education, promotes effective governance arrangements and internal controls in banking institutions. A comprehensive legal framework further supports an effective anti-money laundering/counter financing of terrorism regime in Malaysia, enabling the Bank to have access to information and records, conduct investigations, issue directives and cooperate with other regulatory and enforcement agencies to safeguard the integrity of the financial system.

Table 1

## Level of Compliance with the Basel Core Principles

Basel Core Principles	Level of Compliance
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	C
1.2 Independence, accountability and transparency	LC
1.3 Legal framework	C
1.4 Legal powers	C
1.5 Legal protection	C
1.6 Cooperation	LC
2. Permissible activities	C
3. Licensing criteria	LC
4. Transfer of significant ownership	LC
5. Major acquisitions	LC
6. Capital adequacy	LC
7. Risk management process	LC
8. Credit risk	C
9. Problem assets, provisions, and reserves	C
10. Large exposure limits	LC
11. Exposure to related parties	LC
12. Country and transfer risks	LC
13. Market risks	C
14. Liquidity risk	LC
15. Operational risk	LC
16. Interest rate risk in the banking book	LC
17. Internal control and audit	C
18. Abuse of financial services	C
19. Supervisory approach	C
20. Supervisory techniques	C
21. Supervisory reporting	C
22. Accounting and disclosure	C
23. Corrective and remedial powers of supervisors	LC
24. Consolidated supervision	LC
25. Home-host relationships	C

- **Compliant (C)** – All applicable essential criteria under the Core Principle are met without any significant deficiencies, or when the objectives of the Core Principle are achieved through alternative means.
- **Largely compliant (LC)** – Only minor shortcomings are observed that do not raise any concerns about the authority's ability and intent to achieve full compliance with the Core Principle. For essential criteria that are not met, the overall effectiveness of the authority's regime should be sufficiently high to ensure that no material risks are left unaddressed.
- **Materially non-compliant (MC)** – There are severe shortcomings, despite the existence of formal rules, regulations and procedures. There is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance.
- **Non-compliant (NC)** – There has been no substantive implementation of the Core Principle, several essential criteria are not complied with or supervision is manifestly ineffective.

- **The Bank's supervisory framework provides effective support to its mandates and objectives of maintaining financial stability.** The risk-based supervisory framework provides a systematic and consistent approach to supervision, incorporating a well-integrated programme of on-site and off-site reviews which are also informed by the Bank's macrosurveillance activities. This is further supported by a horizontal risk assessment that facilitates the identification of emerging risks and assessment of the impact on the individual institutions and the overall industry. The Bank communicates its supervisory assessments and concerns in a timely and effective manner, and requires and follows up on corrective actions. The Bank also has the ability to obtain information necessary for its supervisory purposes, can take a wide range of supervisory intervention actions at early stages to avert potential problems and impose penalties for non-compliance with regulatory and legal requirements. This is complemented by a well-developed programme that is in place for information exchange and supervisory cooperation with both domestic and foreign regulatory agencies.

### Key Recommendations

The compliance assessment put forth several recommendations that will ensure existing regulatory and supervisory arrangements continue to be effective in the light of market developments and reflect leading practice. The new financial services legislation addresses many of these recommendations, while the Bank will continue to remain focused on further improving the efficacy of its regulatory and supervisory practices.

The main recommendations are as follows:

- **Further improve the industry consultation process on proposed policy measures to increase the level of public transparency, and provide additional clarity around supervisory expectations and priorities in guidelines and supervisory directives issued by the Bank.** The Bank already widely engages with the industry on proposed regulatory requirements as required under its internal policy development framework. The Bank recognises that engaging effectively with the industry early in the development of regulatory policy can enhance regulatory outcomes. To this end, the industry consultative process on regulatory changes have been extended to include more targeted engagements through focus groups and impact assessments based on detailed inputs from banking institutions to ensure that all relevant views are well understood and carefully considered. In keeping with its principle-based regulatory approach, the Bank is also reviewing its prudential documents to provide better guidance on standards that must be adhered to, and the range of practices that banks may consider to meet such standards that are also proportionate to the size and complexity of the institution. All new prudential guidelines are published on the Bank's website, while existing guidelines which are under review will be published upon completion of the review.
- **Enhance transparency of licensing standards and suitability requirements for shareholders.** This will be achieved under the FSA and IFSA which set out clear criteria for licensing and for the acquisition of significant interests in banking institutions, including criteria applied to assess the suitability of shareholders. Criteria for the assessment of applications for a banking licence have also been enhanced under the new legislation to include an assessment of whether the activities of financial groups will impede effective regulation and supervision by the Bank.
- **Widen the scope of application of the legislative and prudential framework to include financial holding companies and to allow for the supervision of financial groups on a consolidated basis.** To this end, the FSA will empower the Bank to designate and authorise a financial holding company, and apply prudential standards, including capital requirements, liquidity standards, risk management and stress testing expectations on financial groups on a consolidated basis.

- **Issue specific regulations on interest rate risk in the banking book (IRRBB), country risk and operational risk, and fully implement Pillar 2.** The assessment noted that these areas are already the subject of the Bank's ongoing supervisory reviews of banking institutions to ensure that risks are properly identified, assessed and reported to the Bank. The full implementation of Pillar 2 in 2013, following a two-year transition period, will see the intensification of the Bank's supervisory review and examination of internal capital assessment processes, covering, among others, the management of IRRBB and credit concentration risk by banking institutions.
- **Align existing Guidelines on Single Counterparty Exposure Limits with international standards, and expand the scope of application of prudential requirements on credit transactions with related parties to capture significant minority shareholders.** The implementation of the revised Guidelines on Single Counterparty Exposure Limits in March 2013, and the planned review of the Guidelines on Credit Transactions with Connected Parties also in 2013, will significantly enhance compliance in these areas.
- **Establish a comprehensive resolution framework, with clear legislative provisions for determining non-viability of banking institutions, to complement the existing supervisory intervention framework. The framework should also be sufficiently broad in scope and application to allow for the resolution of financial holding companies.** The revised Strategic Alliance Agreement between the Bank and the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia, PIDM), executed in April 2012, improves the coordination of intervention and resolution actions and provides an important platform on which to build the resolution framework. Clear triggers for the determination of non-viability are also addressed under the agreement, thus strengthening the accountabilities of both agencies in ensuring prompt resolutions of troubled institutions. These triggers have been reproduced in the Bank's recently-revised standard on the Capital Adequacy Framework (Capital Components) as conditions under which the Bank may impose losses on holders of bank capital instruments.
- **Expand the application of penalties on individuals under Civil Law.** The new financial services legislation will enable this through provisions that support a more comprehensive penalty framework which encompasses civil, administrative and criminal penalties for breaches of regulatory and legal requirements.
- **Leverage opportunities to foster greater coordination and information exchange with other supervisory agencies, including the home authorities of foreign banks which are active in Malaysia.** Efforts continue to be pursued to further strengthen the Bank's cooperation with domestic regulatory agencies and home supervisors of locally-incorporated foreign banks. Key enhancements were made during the year to cooperation arrangements with Securities Commission Malaysia and PIDM, and the formalisation of information sharing arrangements with the Malaysia Co-operative Societies Commission. The Bank also pursued bilateral engagements with foreign supervisors, and actively hosted and participated in supervisory colleges to enable the exchange of information and coordination of supervisory activities involving cross-border financial groups.

## Assessment of Malaysia's Observance of the IAIS Insurance Core Principles

The Insurance Core Principles (ICPs), first published by the International Association of Insurance Supervisors (IAIS) in 2000, were substantially revised in 2011. The new ICPs are based on a set of high-level principle statements, supported by more specific standards and guidance which are used to assess observance of the ICPs. The new ICPs place greater emphasis on risk-based approaches to regulation and supervision, and provide for the application of the ICPs based on proportionality. Enhancements were also made, particularly in the areas of corporate governance, risk management, group-wide supervision and macroprudential surveillance, to reflect developments in insurance markets and supervision, and to incorporate recommendations of the Group of Twenty Finance Ministers and Central Bank Governors, and the Financial Stability Board (FSB). Malaysia was among the first few countries to be assessed by the International Monetary Fund (IMF) and the World Bank against the revised set of improved ICPs.

This article presents a summary of the assessment and key observations of Malaysia's observance of the ICPs. The detailed assessment is published separately on both the IMF's and the World Bank's websites.

Malaysia was assessed to have either 'observed' or 'largely observed' 22 out of the 26 ICPs (Table 1). Four ICPs relating to prudential requirements on enterprise risk management, group-wide supervision, arrangements for the legal protection of customer funds held by insurance intermediaries, and cross-border cooperation in crisis management were rated 'partly observed'. The assessment noted that the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) will address many of the recommendations for improvements, while ongoing enhancements to existing regulatory requirements to formalise the Bank's supervisory expectations will further enhance Malaysia's level of observance. These enhancements are already well advanced. In particular, the implementation of the Internal Capital Adequacy Assessment Process and the issuance of new requirements on risk governance will strengthen enterprise risk management within insurance companies, while the new legislation affords legal protection for monies received and held in trust by intermediaries for the benefit of insurance/takaful customers.

Malaysia's level of observance of the ICPs on group-wide supervision and cross-border cooperation and crisis management largely reflect the current nature and scope of group-wide exposures and cross-border activities of insurers situated in Malaysia, and the risks that they pose to financial stability. The assessment noted that currently there are no significant domestic insurance groups and that the cross-border activities of Malaysian insurers are limited. For these reasons, the scope and intensity of the Bank's supervision on a group-wide basis as well as the focus on more formal cross-border arrangements for crisis management corresponds to the Bank's view of the relatively low risks from group exposures to insurers in Malaysia. The Bank expects to intensify measures to address group-wide and cross-border issues as and when the activities of insurers expand more significantly and have a wider cross-border presence.

The key findings from the assessment are:

- **A comprehensive legal framework is in place that clearly defines the authority and responsibility of the Bank, and the Bank is accorded with a range of powers that supports its mandate.** Legislation provides for the Bank to be an operationally-independent statutory body, with effective control of its strategic focus and resource allocation to carry out its regulatory and supervisory activities. Officers of the Bank are required to adhere to a code of conduct that promotes high ethical standards. Legal protection is provided to enable the effective performance of their duties.
- **Entry into the industry is subject to rigorous review.** New licences and significant shareholders are assessed against a broad set of financial and non-financial requirements, and a regulatory framework is in place to ensure that the directors, senior management and key persons in control functions possess the competence and integrity to carry out their roles effectively.

Table 1

## Degree of Observance of the Insurance Core Principles

Insurance Core Principles	Level of Observance
1. Objectives, powers and responsibilities of the supervisor	LO
2. Supervisor	LO
3. Information exchange and confidentiality requirements	LO
4. Licensing	LO
5. Suitability of persons	LO
6. Changes in control and portfolio transfers	LO
7. Corporate governance	LO
8. Risk management and internal controls	LO
9. Supervisory review and reporting	O
10. Preventive and corrective measures	O
11. Enforcement	LO
12. Winding-up and exit from the market	O
13. Reinsurance and other forms of risk transfer	LO
14. Valuation	O
15. Investment	LO
16. Enterprise risk management for solvency purposes	PO
17. Capital adequacy	LO
18. Intermediaries	PO
19. Conduct of business	LO
20. Public disclosure	LO
21. Countering fraud in insurance	LO
22. Anti-money laundering and combating the financing of terrorism	O
23. Group-wide supervision	PO
24. Macroprudential surveillance and insurance supervision	O
25. Supervisory cooperation and coordination	O
26. Cross-border cooperation and coordination on crisis management	PO

- **Observed (O)** – All applicable standards are observed. The authority has the legal powers to carry out its duties and demonstrates the exercise of the powers to a satisfactory level.
- **Largely observed (LO)** – Only minor shortcomings are observed, which do not raise any concerns about the authority's ability to achieve full observance.
- **Partly observed (PO)** – Shortcomings are observed that are sufficient to raise doubts about the authority's ability to achieve full observance.
- **Not observed (NO)** – No substantive progress toward observance has been achieved.

- **A comprehensive compendium of prudential requirements and guidance is in place, aimed at promoting safety and soundness, market discipline and integrity of the insurance industry.** This includes extensive expectations on corporate governance and effective risk management and control functions covering an insurer's significant activities. A key cornerstone of the prudential framework is the Risk-Based Capital Framework for Insurers, which captures risks on a total balance sheet approach and requires insurers to maintain sufficient capital to absorb significant unforeseen losses. Valuation and disclosure requirements are aligned with the International Financial Reporting Standards and specifically address required disclosures relevant to insurance contracts. In addition, the Bank publishes an extensive set of industry data on its website.
- **Regulatory requirements address expectations for the fair treatment of customers and are reinforced through the Bank's market conduct surveillance and a structured consumer education programme.** Insurers are required to observe standards of fair dealing in the development of new products, sales and marketing practices including proper advice and disclosures to consumers, and claims settlement. Assessments from the Bank's off-site and on-site monitoring of market conduct practices prompt supervisory actions and decisions to renew the licences of insurance intermediaries. The legislation also provides for severe penalties for insurance fraud and money laundering. The Bank also actively monitors and shares information with relevant authorities to support effective enforcement actions.
- **The supervisory regime is robust and supports effective risk assessments of insurers.** The risk-based supervisory framework enables the systematic and consistent supervision of all licensed insurers, through continuous off-site monitoring, regular on-site inspections and thematic examinations. This is well-integrated with the Bank's macrosurveillance activities and supported by a rigorous stress testing programme. Legislation enables the Bank to take appropriate preventive measures in a timely manner. Supervisory concerns are clearly communicated to insurers and corrective actions closely monitored by the Bank. The Bank also has at its disposal a broad range of tools to implement corrective and enforcement actions, and to cooperate with the Malaysia Deposit Insurance Corporation to resolve distressed insurers in a manner which safeguards the interests of policyholders and minimises costs to the financial system.
- **The Bank adopts a macrosurveillance approach that is commensurate with the nature, scale and complexity of the insurance sector.** The surveillance framework tracks key financial soundness indicators and trends within the insurance industry. Stress testing is conducted regularly, and combines both a macro (top-down) and micro (bottom-up) approach. In addition, work by the Bank is underway to develop a framework to assess the systemic importance of insurers based on guidance developed by the FSB.

### Key Recommendations

The assessment noted several recommendations for further improving Malaysia's observance of the ICPs. A number of these recommendations are relevant to more developed insurance markets and are expected to gain greater significance for Malaysia as the domestic industry grows further in size and complexity. These recommendations are included in the Bank's medium- to longer-term plans.

As with the assessment on Malaysia's compliance with the Basel Core Principles for Effective Banking Supervision, similar recommendations have been made for improving transparency in licensing and suitability requirements for shareholders, and for the regulation and supervision of financial holding companies to support the supervision of insurers on a group-wide basis (refer to box article 'Assessment of Malaysia's Compliance with the Basel Core Principles for Effective Banking Supervision'). This has been addressed in the new FSA and IFSA. As also noted above, risks associated with the cross-border activities of domestic insurance groups remain low at present. In practice, informal arrangements have been established with host supervisors in jurisdictions where Malaysian insurance groups have cross-border operations. The supervisory approach also incorporates an ongoing assessment of potential risks arising from activities of related entities that may impact the

financial condition of insurers in Malaysia. The Bank remains committed to further strengthening its existing cooperation and exchange of information arrangements with other supervisors and authorities, including through wider participation in bilateral memoranda of understanding and by strengthening capabilities to support effective cross-border crisis management and resolution as appropriate to the risks posed by insurers' cross-border activities.

Recommendations were also made to review and update a number of regulatory requirements to incorporate principles of sound practice that the Bank already demands of insurers through its supervisory activities. This is being implemented under an ongoing programme to regularly review the existing requirements in line with the Bank's internal policy development framework.

Other recommendations include the following:

- **Strengthen enforcement tools and implement a supervisory framework specific to market conduct activities.** The new FSA and IFSA establish specific provisions for the Bank to issue and enforce standards of business conduct. A major development in the Bank's regulatory agenda has been the development and implementation since 2011 of a more structured and integrated framework for supervising market conduct risks. This is now fully operational, providing for more effective assessments of risks to consumers that draw on a broad range of information and more targeted supervisory activities. Provisions for administrative and civil penalties in the new FSA and IFSA will further support effective enforcement of market conduct standards by the Bank.
- **Develop a more comprehensive capital framework for financial guarantee insurance.** Danajamin Nasional Berhad, Malaysia's only financial guarantee insurer, is subject to equivalent requirements on corporate governance and risk management that apply to other financial institutions regulated by the Bank. It must also comply with prudential exposure limits on a single and aggregate basis which are commensurate with its financial capacity. Moving forward, the Bank intends to put in place a more comprehensive and risk-sensitive capital framework for financial guarantee insurance business which will better capture the risks inherent in the business, while reinforcing incentives for sound risk management. This will also lend support to the sustainable growth of Danajamin as it continues to expand its role in providing credit enhancements to more Malaysian corporations and in a wider array of economic sectors.
- **Provide for interdependencies between and within risk categories under the capital framework.** Stress testing requirements currently help to identify risk correlations and inform management decisions regarding the adequacy of financial buffers for addressing synchronous risks and spillovers from specific risk events. The Bank intends to further enhance the capital requirements in the future to account for the effects of risk correlations as more data becomes available to support such refinement to the framework.