

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.