

## **Proposals for New Legislative Framework for Financial Regulation and Supervision**

In 2011, the Bank completed a comprehensive review of existing regulatory laws governing financial institutions, markets and payment systems under the Bank's purview. The review built on the foundations for promoting financial stability that have been established in the Central Bank of Malaysia Act 2009, and in particular, puts forward proposals to support three primary functions of the Bank under that Act – regulating and supervising financial institutions under the Bank's purview, providing oversight over the money and foreign exchange markets, and exercising oversight over the payment systems.

The review aims to ensure that the regulatory laws remain current and effective in enabling the Bank to discharge its regulatory and supervisory mandate in a way that would preserve the stability of the financial system, while recognising important differences between the regulated industries and institutions. The Bank drew extensively on its experience in regulating the financial sector and the resolution of financial institutions as well as lessons and recommendations emerging from the global financial crisis that served as inputs to the review. The review focused on the following key outcomes:

- Opportunities for regulatory arbitrage should be minimised through a consistent approach in dealing with similar risks in the financial system, regardless of where they originated. In line with this, proposed changes also aimed to close current gaps in legislation with respect to the oversight of business conduct, group-wide supervision, and systemically important financial institutions that were not subject to prudential supervision.
- Regulation and supervision should be proportionate to the risks posed by regulated institutions and markets.
- The Bank should have the ability to take early actions to avert failures, including sufficient flexibility to influence and correct imprudent market behaviours in a timely manner as conditions changed.
- Where failures did occur, the Bank should have the necessary tools to minimise losses to depositors and policyholders as well as costs to the overall financial system.
- There should be clarity of supervisory mandates for which the Bank is accountable, and an appropriate level of transparency in the way that the Bank discharged those mandates.

A starting point for the review is the proposed consolidation and rationalisation of existing regulatory laws to achieve a more cohesive legislative framework. A dual framework will be maintained for the conventional and Islamic financial business consistent with the dual financial system in Malaysia. Within this dual framework, the prudential and market conduct supervision of institutions and markets under the Bank's purview will be integrated under the proposed new legislation which will replace the existing Banking and Financial Institutions Act 1989, Islamic Banking Act 1983, Insurance Act 1996, Takaful Act 1984, Payment Systems Act 2003 and Exchange Control Act 1953.

Other key recommendations from the review are discussed below.

### **Clarity of Regulatory Objectives**

In pursuing the principal object of the Bank to safeguard financial stability, the proposed legislation seeks to provide clarity on the accountability of the Bank. This allows for directing resources to the key responsibilities, while carefully balancing the outcomes of regulation and supervision that drive the Bank's priorities. It will also serve to identify areas where coordination with other authorities will be important. The proposed legislation accordingly aims to reflect the Bank's current commitment to foster: (i) the safety and soundness of financial institutions; (ii) the integrity and orderly functioning of the money market and foreign exchange market; (iii) reliable, safe and efficient payment systems and payment instruments; and (iv) fair, responsible and professional

business conduct of financial institutions. This will provide clarity on the observance of international core principles on effective banking and insurance supervision which require the mandates and responsibilities of the regulator to be clearly specified in legislation.

### Differentiated Intensity of Regulation and Supervision

Under the Bank's risk-based approach to supervision, the scope and coverage of regulatory requirements and level of supervisory intensity applied to institutions and markets under the Bank's purview are differentiated based on the level of systemic risk posed by such institutions or markets. Systemic risk refers to the potential for the failure of an institution or market that will disrupt the financial intermediation process, the orderly functioning of key markets, or precipitate a general loss of confidence in the financial system. In line with this approach, the review aims to provide a clearer distinction in the legislation, specifically through differentiated frameworks described below, to promote a more transparent and accountable regime in which powers accorded to the Bank are proportionate to the need for such powers in order to deliver the Bank's legislated mandates.

	Applicable regime (proposed)	Intensity of Regulation and Supervision
<ul style="list-style-type: none"> <li>Banking institutions</li> <li>Insurers</li> <li>Takaful operators</li> </ul>	Licensing	Subject to comprehensive prudential, business conduct and consumer protection requirements.
<ul style="list-style-type: none"> <li>Systemically important payment systems</li> </ul>	Designation	Subject to requirements to ensure the safety, efficiency and reliability of designated payment systems.
<ul style="list-style-type: none"> <li>Insurance/takaful brokers</li> <li>Money brokers</li> <li>Financial advisers</li> <li>Payment system operators</li> <li>Designated payment instruments issuers</li> </ul>	Approval	Subject mainly to business conduct and consumer protection requirements.
<ul style="list-style-type: none"> <li>Loss adjusters for insurance or takaful claims</li> <li>Providers of merchant acquiring services in conjunction with payment systems</li> </ul>	Registration	Oversight primarily focused on promoting professional conduct in activities that relate to businesses that are licensed or approved.

### Transparent Assessment Criteria for Authorisation and Shareholder Suitability

A key aspect of a sound financial regulatory system is a rigorous process for authorising institutions to carry on regulated financial businesses, including assessment of their significant owners and controllers. The Bank proposes to improve the transparency of this process and reinforce the integrity of the regulatory framework, by defining the factors that are taken into consideration in admitting institutions into the financial sector. It also seeks to pre-emptively manage concerns on complex structures and incentives or conditions that encourage excessive risk-taking which can significantly complicate the effective supervision of financial institutions. The proposed factors therefore include, in addition to an institution's financial strength and track record, a consideration of whether it can demonstrate sound and realistic business plans for its operations, the extent to which its corporate structures could impede effective regulation and supervision, and the potential for altering market structures or conditions in a way that would increase risks to financial stability.

### Provisions for Oversight over Non-regulated Institutions

A focus of reforms following the global financial crisis has been around concerns that the coverage of prudential supervision has been too narrow. This has led to calls for regulatory regimes to take

appropriate account of systemic risks that can emerge from the interaction between regulated and unregulated institutions, activities and markets. The Central Bank of Malaysia Act 2009 provides for the Bank to obtain information on institutions that are systemically important, and where necessary direct an institution not regulated by the Bank to take specific measures to avert a risk to overall financial stability. These important powers were designed to promote financial stability, and are corrective in nature to respond to specific risks to financial stability. There is now wide consensus, including by the Financial Stability Board, that it would be necessary for non-bank institutions with significant financial intermediation activities or which are closely connected with the banking system to be brought under a system of continuing prudential oversight to minimise any regulatory arbitrage and promote conduct that is compatible with financial stability. Based on this rationale, it is recommended that the Minister of Finance may subject an institution that is engaged in financial intermediation activities to ongoing regulation and supervision if it is determined that the institution poses or is likely to pose a risk to overall financial stability.

### **Greater Focus on Business Conduct and Consumer Protection**

While current regulatory laws impose clear obligations for financial institutions to comply with prudential regulatory prescriptions that promote safety and soundness, the obligation to comply with business conduct requirements is less defined. This has to some extent limited the enforcement actions that the Bank can take, including public action, to address business conduct concerns. The proposed legislation seeks to close this gap in three main ways: (i) charging the Bank with a clear mandate for consumer protection with respect to the conduct of financial service providers regulated by the Bank; (ii) clarifying the obligations of financial service providers to comply with business conduct standards, and equipping the Bank with effective tools to enforce these standards; and (iii) strengthening existing arrangements for consumer redress through the approval and oversight by the Bank of a financial ombudsman scheme for the resolution of disputes involving financial service providers under the Bank's purview. However, this will not alter the existing arrangements with regard to market conduct of investment banks which are now under the purview of the Securities Commission.

### **Flexibility to Specify Prudential and Business Conduct Standards**

Consistent with the differentiated intensity of regulation and supervision, it is important for the Bank to be able to: (i) specify prudential and business conduct standards that may be differentiated between regulated institutions or categories of regulated institutions according to their risk profiles; and (ii) calibrate such standards over time as conditions require, to address new or emerging risks. This also results in important efficiency gains in allowing the Bank to provide appropriate flexibility to institutions to manage their business in the most optimal way when the risks have been effectively managed. To this end, specific recommendations have been made to recast existing requirements and introduce new provisions that will support this flexibility. The provisions include specific responsibilities placed on the board to oversee the risks and internal control strategies of financial institutions to promote their long-term viability and fair dealings towards consumers.

### **Sharper Focus on Shariah Compliance and Governance in the Islamic Financial Sector**

In a dual financial system in which conventional and Islamic financial products are offered in parallel, a critical aspect of the regulatory framework is the consistency of rules and regulations across both sectors to eliminate possibilities for regulatory arbitrage. At the same time, there is a need to reflect the fundamental differences in the nature of risk inherent in Islamic financial products and services. The proposed new legislation for Islamic finance seeks to provide greater visibility to Shariah compliance and the effective implementation of Shariah governance by Islamic financial institutions, thus ensuring a coherent regulatory framework. Among others, proposed provisions have been put forward to allow the Bank to specify standards on Shariah matters, including on Shariah governance, principles and practices of Shariah in relation to the business and affairs of an Islamic institution, as well as requirements for Shariah compliance audits. In line with Shariah requirements, the proposed new law will also clarify the process and priority of payments in the event of a winding up of a financial institution involved in Islamic financial business.

**Strengthened Ability to Supervise Financial Groups on Consolidated Basis**

The effective supervision of financial groups has emerged as one of the more important charges of the regulatory reform agenda in the wake of the global financial crisis. The primary prudential aim of group supervision is to minimise contagion risk from group operations that could affect the safety and soundness of regulated institutions within a group. While current legislation and practice support the supervision of regulated institutions on a solo basis, the framework for the supervision of financial groups is not as well-advanced. To support the Bank's current work to put in place appropriate formal arrangements, including prudential requirements for the supervision of financial groups, the proposed new legislation seeks to provide a clear mandate for the Bank to exercise oversight over financial groups that have one or more licensed institutions within the group. This includes powers for the Bank to formally authorise financial holding companies, obtain information on and examine any entity within the group, apply appropriate prudential standards to the holding companies or other subsidiaries, and require corrective measures to be taken to mitigate any identified risks to the licensed institution or the financial group. Such powers will be supplemented with enhanced provisions for the Bank to cooperate with other domestic or foreign supervisory authorities, in areas including the sharing of supervisory information and the conduct of examinations.

**Enhanced Supervisory Interventions**

Central to the Bank's current supervisory approach is the early identification of risks, and a robust process for progressively escalating the intensity of supervisory interventions. Reflecting this approach, proposed legislative changes will also seek to strengthen the Bank's ability to intervene at an early stage. The proposals seek to expand the range of pre-emptive supervisory tools available to the Bank to address a problem, and allow for different approaches to be taken in circumstances where an institution's problems are less serious and the management is cooperative, as opposed to situations that require more formal actions with severe penalties for non-compliance. This is consistent with promoting supervisory measures that are proportionate. Proposals include strengthened provisions for the Bank to direct an institution to take specific remedial actions to address the Bank's concerns, and the ability to enforce commitments by institutions to implement measures designed to maintain the safety and soundness of the institution. It is also proposed that the enhanced supervisory interventions be reinforced with a new penalty framework that will include, in addition to criminal sanctions, the ability for the Bank to impose monetary or non-monetary administrative penalties and pursue civil actions, thus allowing for more expedient enforcement actions which are proportionate to the nature and gravity of non-compliances.