

2011

REGULATORY AND SUPERVISORY FRAMEWORK

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INTRODUCTION

The regulatory and supervisory framework continued to support financial stability in Malaysia in the face of continuous risks in the external environment and heightened domestic competition. The framework has also stood up well against the changing character of the domestic financial system which saw the entry of new market participants and the more pronounced regional and international complexion of the financial sector. In 2011, the Bank continued to reinforce and advance further the core tenets of regulation and supervision, building on earlier work undertaken to strengthen the legislative framework and improve risk management, governance and business conduct practices. The progress made on the global regulatory reforms also had an important bearing on the Bank's work. While taking these reforms carefully into account, the Bank has remained focused to ensure relevancy of the reforms and achievement of the intended outcomes. The Bank has continued to leverage its supervisory insights and engagements with the industry to further enhance the integrity and strength of the regulatory and supervisory system in Malaysia.

REGULATORY DEVELOPMENTS AND SUPERVISORY ASSESSMENTS

Regulatory capital and liquidity standards

Further to the announced plans to implement the Basel III reform package in Malaysia in December 2011, the Bank released details on the implementation plan, including the timelines. The plan sets out the Bank's expectations of banking institutions in transitioning towards the new regime, which also includes the approach to be adopted by banking institutions for the individual components of the reform package.

The Basel III reform package seeks to strengthen global capital and liquidity standards for banking institutions by improving the quality and quantity of regulatory capital and ensuring adequate high-quality liquidity buffers. These standards will be implemented in Malaysia in phases, beginning 2013 until 2019, in line with

the globally-agreed levels and implementation timelines as illustrated in Table 3.1. While the banking system in Malaysia is well-positioned to meet the requirements of the new regime within a shorter timeframe, the adoption of the extended timeframe set by the Basel Committee on Banking Supervision (BCBS) will allow for more gradual adjustments by banking institutions to the new requirements, thus mitigating any adverse impact on credit intermediation, particularly in an environment of slower global growth. The current performance trend and projections for banking institutions in Malaysia suggest that the capital requirements can be largely met through prudent earnings retention policies over the period of implementation, thereby avoiding potential market dislocations from synchronous capital-raising actions by the banking institutions.

The current performance trend and projections for banking institutions in Malaysia suggest that the capital requirements can be largely met through prudent earnings retention policies over the period of implementation

In addition to the new minimum regulatory capital levels, a primary element of the Basel III reform package is the revised **definition of regulatory capital** which is intended to ensure higher levels of high-quality and loss-absorbent capital. Going forward, common equity, comprising paid-up capital and retained earnings will form the predominant component of Tier-1 capital, thus substantially strengthening the loss-absorbing capacity of banking institutions. Following a detailed assessment of the rules text, the Bank has identified potential areas where implementation could present some challenges for the domestic banking system. These include overcoming the

operational complexities of the methodologies specified by the BCBS for the treatment of deferred tax assets as well as the investments in capital instruments of other financial institutions. The Bank will consult with the industry and market participants on proposals to enhance the loss absorption qualities of capital instruments, particularly on a going concern basis. This would involve requiring all capital instruments to contain provisions for a principal write-down or conversion into common equity when an institution becomes non-viable ("gone concern" basis), or when its capital falls below pre-specified triggers ("going concern" basis). A concept paper on the revised regulatory capital definition will be issued for industry feedback in the first half of 2012. Beginning 2016, banking institutions will also be required to hold a capital conservation buffer that can be drawn upon during periods of stress.

Basel III also introduces a **leverage ratio** which is intended to mitigate the effects of excessive deleveraging in the banking system during distressed periods. While the BCBS has targeted implementation of the ratio from 2018, the

Bank will require banking institutions to begin reporting their leverage positions beginning June 2012. The leverage position reporting would allow the Bank to assess the impact on the behaviour of banking institutions and identify any unintended consequences. This includes the possibility that the non-risk-based nature of the ratio may lead banks to favour higher-risk activities at the expense of low-risk, but economically productive activities such as trade financing. While banking institutions are expected to meet the requirement, a decision to formally adopt the leverage ratio as a binding measure, as well as the need to fine-tune the measurement of the ratio, will be determined by the Bank closer to the targeted 2018 deadline.

The strengthened **liquidity standards** proposed under Basel III will be implemented through enhancements to the existing Liquidity Framework that has been in place since 2000. Similar to the leverage ratio, an "observation period" will begin in June 2012 with the requirement that banking institutions report both the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) positions before the measures become binding in 2015

Table 3.1

Phase-In Arrangements for the Implementation of Basel III in Malaysia¹

	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Observation period						Standard in force	
Minimum common equity		3.5%	4%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer					0.625%	1.25%	1.875%	2.5%
Minimum common equity plus capital conservation buffer		3.5%	4%	4.5%	5.125%	5.75%	6.375%	7%
Minimum Tier-1 capital		4.5%	5.5%	6%	6%	6%	6%	6%
Minimum Tier-1 capital plus capital conservation buffer		4.5%	5.5%	6%	6.625%	7.25%	7.875%	8.5%
Minimum total capital		8%	8%	8%	8%	8%	8%	8%
Minimum total capital plus capital conservation buffer		8%	8%	8%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify	Phased out over a 10 year horizon beginning 2013							
Liquidity Coverage Ratio	Observation period			Standard in force				
Net Stable Funding Ratio	Observation period						Standard in force	

¹ All dates are as of 1 January. Shading indicates transition periods.
Source: Bank Negara Malaysia

and 2018 respectively. The Bank shares similar concerns expressed by a number of supervisory authorities that the liquidity standards, as currently calibrated, do not adequately address the specific characteristics of funding markets that are unique in some countries. For example, in Malaysia, institutional savings schemes (such as the Employees Provident Fund) capture a significant share of household savings which are in turn deposited by the schemes with banks. Under the standards, such deposits are subjected to severe withdrawal assumptions (or “run-off” rates) which are not reflective of the profile of the underlying liquidity risks. Data collected from the observation period will be used to consider appropriate adjustments to the run-off rates where needed. An area that will be monitored during the observation period is the potential impact on market liquidity arising from an increase in captive demand by banking institutions for eligible liquid assets and how this in itself may alter the characteristics of such instruments in terms of the availability to meet liquidity needs in times of stress. The requirements under the liquidity standards are also likely to have significant impact on Islamic banks given that investments must comprise only Shariah-compliant instruments. To facilitate compliance with the standards, the Bank will encourage and support the development of solutions by the industry to deepen the sukuk market, while cooperating with other agencies to formulate an appropriate regulatory framework for the issuance of new instruments by banking institutions. The Bank is also concerned that the NSFR in particular should not undermine the important maturity transformation role of banking institutions and would consider suitable options for the NSFR implementation.

For the insurance industry, a number of planned enhancements to the **Risk-Based Capital Framework** (the RBC framework) were completed in 2011. This included the necessary changes to converge the valuation rules for financial instruments under the RBC framework with the Financial Reporting Standards 139. Following the adoption of the FTSE Bursa Malaysia KLCI as the main index for the equity market in July 2009, the calibration of market risk charges for indexed investments was also reviewed to ensure that the treatment for the new index reflects the relative volatility of the constituent stocks.

However, these changes had minimal impact on the capital adequacy positions of insurers. Work on more fundamental enhancements to the RBC framework is continuing, including proposals to refine the valuation methodology for life insurance liabilities and the treatment of reinsurance arrangements. Another important area of review is ensuring consistency between current capital buffers provided under the RBC framework and the implementation of more robust internal capital management processes for insurers. This will also take into account ongoing developments in the Common Framework for the Supervision of Internationally Active Insurance Group (ComFrame) that are being advanced by the International Association of Insurance Supervisors (IAIS). One of the objectives of the ComFrame is to foster global convergence of regulatory measures, including regulatory capital, and supervisory approaches for internationally-active insurance groups, a number of which have significant operations in Malaysia. The IAIS has also released the revised Insurance Core Principles that further define sound practices in solvency assessments which will inform the Bank’s work. The Bank will review the RBC framework with the objective to further improve the alignment of capital with risk and support a more consistent approach to capital standards for financial groups, while at the same time preserving a prudent level of capital that is appropriate for the operating environment in Malaysia.

In April 2011, the Bank issued a concept paper on **Risk-Based Capital Framework for Takaful Operators** (RBCT). During the industry consultation, a number of issues were raised, including Shariah-compatible options that could incentivise takaful operators to build strong takaful funds, the treatment of *Qard* as a component of capital available and the calibration of risk charges for general takaful and expense liabilities. Following the feedback received, the RBCT proposals are being refined to take into account the objectives of prudential and Shariah principles. At the same time, the trigger point for shareholders’ provision of *Qard* to restore deficits in the takaful fund was clarified through the issuance of the revised Guidelines on Takaful Operational Framework in September 2011. This guidelines help ensure that standardised practices are adopted by takaful and retakaful operators in addressing deficits in takaful and retakaful funds in a timely manner.

Banking institutions' internal processes for capital management were subjected to greater scrutiny by the Bank following the issuance of the Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) in 2010. The guidelines set out the Bank's approach to **Pillar 2** (Supervisory Review Process), which require each banking institution to assess the adequacy of capital relative to its risk profile, including risks which are not covered or fully captured under Pillar 1. Full compliance with the requirements of the guidelines is expected by end-2012. Supervisory reviews of banking institutions' implementation of the ICAAP were initiated in 2011, focusing on the quality of board and management oversight of the ICAAP, integration of the capital planning process with risk appetites, the robustness of frameworks to identify and measure material risks, and the methodologies adopted by banking institutions for incorporating stress scenarios in the determination of internal capital targets. In general, the Bank observed improvements in the processes and methodologies applied for measuring material risks and in estimating the level of capital required, both at the entity and group level. Banking institutions were observed to make better use of stress test results in capital planning. Nonetheless, there is scope for further improvements in banking institutions' measurement and capital allocation for non-Pillar 1 risks, including concentration risk, as well as the quality and integrity of systems and processes for risk reporting, and model development and validation.

In the insurance industry, all insurers must set and observe on a continuing basis individual target capital levels that are determined by the insurer and agreed with the Bank. Progress has similarly been observed in the capital management processes of insurers. This progress was uneven among insurers, leading the Bank to require a few insurers to undertake corrective measures, including improving systems to capture risk and adopting prudent earnings retention policies to shore up capital reserves. This was followed by the issuance of the concept paper on Guidelines on ICAAP for Insurers in September 2011 on the expectations on insurers for sound capital and risk management.

Risk management and prudential framework

A clear focus on risk management remained central to the Bank's regulatory and supervisory priorities. Over the years, and as a result of a sustained focus by the Bank in this area, there

has been closer alignment between the Bank's expectations and the risk management practices observed among financial institutions. In 2011, the Bank saw continued improvements in two notable areas. One was the more explicit reflection of the risk appetite and risk tolerance set by the board in an institution's business plans and strategies. The second was more effective risk oversight provided by the board and risk committees in providing constructive feedback and challenge to the business strategy development process. In the light of recent global developments in risk management approaches and perspectives, the Bank views that future progress in risk management practices within Malaysia's financial services industry would benefit from specific guidance, including where appropriate, clear requirements on effective risk governance. This would also serve as a focal point for more effective interactions between the Bank and financial institutions on risk issues and developments concerning an institution.

In February 2012, the Bank released an updated concept paper on sound **risk governance** practices, incorporating industry feedback on the earlier paper, developments in international standards and leading practices in risk governance, and supervisory observations on existing domestic practices. Key areas of emphasis in the concept paper issued by the Bank are on: (i) the role of the board in setting and controlling an institution's risk strategy and risk appetite; (ii) promoting a sound understanding of the institution's group structures to ensure that exposures arising from interactions with other group entities are clearly understood and managed; (iii) incentive and remuneration systems that are aligned with a sound risk culture; (iv) clear mandates, independence and appropriate stature of the chief risk officer and the risk management function; and (v) effective and rigorous oversight of internal risk assessments and models, including processes that adequately challenge the integrity, limitations and reasonableness of any judgments applied. The Bank expects to finalise the standards for adoption in the second half of 2012.

An important component of the prudential framework adopted for managing risks in the banking system is the limit imposed on banking institutions' **exposures to individual counterparties** or groups of connected counterparties. The prudential limit serves as a

regulatory backstop measure to safeguard against risk concentrations to particular counterparties that could materially threaten a bank's financial position. During the year, the Bank completed a significant review of the existing prudential framework, including its coverage, to ensure that the limit would continue to fulfil its purpose of containing risk concentrations in an environment which has become more interconnected, with risk correlations being correspondingly more pronounced. Several enhancements to the single counterparty exposure limit framework are being proposed, including: (i) an expanded definition of counterparties that includes counterparties connected due to economic dependence; (ii) a broader scope of exposures to capture both on- and off-balance sheet exposures; (iii) recognition of selected credit risk mitigation techniques to reduce exposures; (iv) a defined approach for measuring exposures to collective investments and similar schemes; and (v) incorporation of sound practices for managing name risk concentration.

With the intense competition in the retail lending space, the Bank maintained its heightened supervisory vigilance on the **credit risk management practices** of banking institutions. There were signs of continued pressure on the pricing of retail lending products although supervisory reviews of actual lending practices suggest that the most aggressive lending rates are mostly applied selectively to customers with low risk profiles. There were some isolated cases in which banking institutions had reduced vigilance over breaches of lending policy and adopted highly optimistic assumptions in pricing policies. These banking institutions have been required to take appropriate remedial measures and remain under close scrutiny for any further signs of deterioration in underwriting standards. As a broader pre-emptive measure, the Bank issued a concept paper on Guidelines on Risk-Informed Pricing for Retail Loans/Financing in December 2011 to strengthen the oversight of, and promote more risk-informed approaches to retail loan pricing. The guidelines set out the Bank's supervisory expectations on the board's oversight responsibilities and internal controls in pricing of loans, as well as the pricing components that should be reflected in banking institutions' pricing methodologies. While the Bank does not have prescribed pricing levels, the proposed guidelines seek to ensure that banking

institutions price risk appropriately based on realistic assumptions and with a complete understanding of the key risk drivers involved. The Bank expects to finalise the proposed guidelines in the second quarter of 2012 after assessing the feedback received.

As a broader pre-emptive measure, the Bank issued a concept paper on Guidelines on Risk-Informed Pricing for Retail Loans/Financing in December 2011 to strengthen the oversight of, and promote more risk-informed approaches to retail loan pricing

Following consultations with the Islamic banking industry on proposals to strengthen the governance and transparency in the management of **displaced commercial risks** through the use of the profit equalisation reserve (PER), the Bank issued the revised Guidelines on Profit Equalisation Reserve in May 2011. The enhancements contained in the guidelines serve three important purposes: (i) supporting the proper attribution of PER to banking institutions and investment account holders based on the contractual profit-sharing ratio; (ii) improving disclosures on PER in the financial statements, including disclosures on the institution's accounting policy for the computation and apportionment basis for PER and detailed movements of PER during the financial year; and (iii) strengthening the accountability of Islamic banks' Shariah committees for ensuring the appropriateness of profit distributions and amounts to be transferred to PER. These outcomes have also helped achieve compatibility between the use of PER and its treatment under the Financial Reporting Framework adopted in Malaysia.

Corporate governance

The Bank continued to observe sustained improvements in the corporate governance practices of banking institutions and insurers. In particular, the boards of directors are playing a more active role in setting and overseeing

the effective implementation of risk policies, business strategy and capital management. There has also been an increase in the number of independent directors represented on the boards, with greater attention by the nominating committees to improve the mix of relevant competencies and experience of boards. The vast majority of non-executive directors appointed to the boards of banking institutions and insurers during the year had strong backgrounds in risk, finance, banking or insurance business. The Bank also noted an increased level of engagement between the nominating committees and proposed board members, indicating a higher level of due diligence conducted by nominating committees. This followed an enhanced process implemented by the Bank to seek assurances from the board that it was satisfied with a candidate's ability to contribute effectively to the board's oversight role. Nonetheless, the renewal of board members remains a challenge for many financial institutions. Greater effort is needed to develop a wider pool of qualified independent directors that can serve on the boards of financial institutions. In support of this effort, the Bank is working closely with the Malaysia Deposit Insurance Corporation (PIDM), the International Centre for Leadership in Finance, and the Financial Institutions Directors' Education (FIDE) Forum (members include directors who have attended the FIDE programme) to establish a programme for the development of a pool of potential directors for boards of financial institutions. This programme is expected to commence with the process of identifying individuals for the talent pool in 2012.

A firm commitment to directors' education has been instrumental in improving the quality of board oversight within the financial sector. The number of directors who have completed the core FIDE programme increased further to 437 in 2011. More than 230 directors have supplemented this training by attending more specialised programmes on specific board roles and governance issues offered under the FIDE programme. In response to strong demand for such programmes, FIDE's complement of specialised or elective programmes has grown from three initially, to 13 in 2012.

Under a functional approach to regulation, prudential standards on corporate governance are largely aligned across the financial

industries regulated by the Bank. The remaining differences reflect specific supervisory priorities of the Bank given the stage of development of an industry and the capacity to comply with higher standards. These differences have narrowed over time, most notably among development financial institutions (DFIs) that have been required to observe governance standards that are consistent with those applied to banking institutions and insurers. The Bank views this as a critical enabler for the DFIs to fulfil their development mandates more effectively and in a sustainable manner. In September 2011, the requirements to ensure the fitness and propriety of key responsible persons, earlier adopted for banking institutions and insurers, were extended to DFIs. A key aim of the requirements is to strengthen the role and accountability of the board, supported by sound processes for suitability assessments, in appointing and retaining individuals in key responsible positions within the DFIs.

Consumer and market conduct regulatory and supervisory framework

In the aftermath of the global financial crisis, there has been an increased focus globally on consumer conduct issues, not only in protecting individuals from excessive risk, but also in protecting the financial system from systemic risk. As the authority responsible for the conduct of business by financial institutions under the Bank's purview, the Bank has long recognised the need for a regulatory framework that supports responsible financial behaviours and fair outcomes for consumers. This is achieved through market conduct regulations that: (i) promote a stronger alignment between the interests of financial institutions and their consumers; and (ii) afford appropriate protection to consumers against harmful practices.

During the year, the Bank extended its market conduct focus to developments in the wider macroprudential context. The more challenging economic environment, intense competition and strong growth in retail lending activities had increased the potential for imprudent and irresponsible practices among lenders that may lead to adverse outcomes for consumers and risks to the broader financial stability. While the impaired loans ratio for lending to the household sector has remained low and stable, the Bank moved pre-emptively to reinforce sound underwriting standards that also serve to protect consumers from the unaffordable

accumulation of debt. In November 2011, the Bank issued the **Guidelines on Responsible Financing** which promotes more consistent practices across the industry in assessments by financial institutions of the creditworthiness of customers and their ability to service debt obligations. Under the guidelines, affordability should be determined through the observance of prudent debt service ratios and throughout the tenure of the loan. Standards that must be observed by lenders in verifying the income of prospective borrowers were also strengthened, along with expectations for lenders to improve engagements with customers on the ability to service debt obligations without recourse to additional debt.

In November 2011, the Bank issued the Guidelines on Responsible Financing which promotes more consistent practices across the industry in assessments by financial institutions of the creditworthiness of customers and their ability to service debt obligations

To support responsible borrowing decisions on the part of consumers, lenders must also provide specific and clearly disclosed information on the total repayment amount, total finance cost as well as the impact of an increase in the financing rate so that consumers understand the full implications of a borrowing decision. This follows earlier measures during the year to prohibit credit card issuers from increasing credit limits without obtaining the prior consent of cardholders, and providing unsolicited credit advances. Disclosures to cardholders were also enhanced to draw the attention of consumers to the financial implications of paying less than the full amount of outstanding credit card balances in efforts to encourage better financial discipline.

In the Islamic banking sector, consumer outcomes were improved with the greater harmonisation of practices in two areas. This concerned the offering of waivers to customers of **sale-based financing**

contracts (such as *murabahah* and *bai' bithaman ajil*) upon early settlement. The guidelines were issued by the Bank to mandate the granting of *ibra'* to all customers upon early settlement, which must observe requirements governing its calculation and disclosure. The second area relates to **late payment charges** which may be imposed by Islamic banks. A lack of clarity in the permissibility and treatment of such charges from a Shariah perspective risked encouraging unhealthy consumer behaviours in which delinquent borrowers may systematically prefer payments of debt obligations to conventional banks over Islamic banks. More generally, this would undermine efforts to promote prudent financial discipline among Malaysian borrowers. To address this, the Bank established the parameters for the imposition of penalties (*gharamah*) and compensation charges (*ta'widh*) on delinquent consumers of Islamic financial products and services (see Table 3.2). The parameters provide a common standard for the computation of late payment charges with due consideration to defaulters with genuine financial difficulties. In line with Shariah principles, *ta'widh* received may be recognised as income, while *gharamah* receivables must be channelled to charity.

More generally, the Bank continued the efforts to improve the **transparency of fees and charges** imposed by financial institutions on consumers and other retail customers and took firm actions against prohibited or excessive fees and charges which saw more than RM4 million in such fees being refunded by financial institutions to customers during the year.

With effect from 1 August 2011, insurers and takaful operators are required to advise customers on the market value of the vehicle insured at the point of purchase or renewal of motor insurance based on a credible valuation database

As part of a broader initiative to improve the conduct of business in the motor insurance and takaful sector, particularly with respect to **claims settlement practices**, the Bank introduced

Table 3.2

Guidelines on Late Payment Charges for Islamic Banking Institutions

Components of combined late payment charge	Policy requirements
<p><i>Ta'widh</i> (compensation charge)</p>	<p>Islamic banks are allowed to be compensated by way of <i>ta'widh</i> based on the actual amount of losses incurred.</p> <p>However, this amount shall not be more than 1% per annum of:</p> <ul style="list-style-type: none"> ■ the overdue instalments of the Islamic product in the case of default of scheduled payments; or ■ the outstanding balance of the Islamic product where a default results in the entire facility being recalled or brought to court for judgment prior to maturity. <p>For delays occurring after maturity of a financing contract, Islamic banks are only allowed to charge <i>ta'widh</i> at a reduced rate based on daily overnight Islamic interbank money market rate.</p>
<p><i>Gharamah</i> (penalty)</p>	<p><i>Gharamah</i> is determined based on the difference between the combined late payment charges (capped at the respective Islamic bank's average financing rate at the point of default) and the amount of <i>ta'widh</i> imposed.</p> <p>The administration of <i>gharamah</i> distribution to approved benefactors or charitable organisations shall be determined by the Islamic bank's Shariah committee.</p>

specific measures to reduce the scope for over- or under-insuring motor vehicles, which had been a common source of complaints from consumers who were not compensated in full following an insurance or takaful claim. With effect from 1 August 2011, insurers and takaful operators are required to advise customers on the market value of the vehicle insured at the point of purchase or renewal of motor insurance based on a credible valuation database. In the event of a subsequent claim, the insurer or takaful operator must use the same reference database to determine the market value of the vehicle. This has had a positive effect in aligning the expectations of consumers and helping consumers determine with greater confidence the value at which to insure the vehicles.

Based on feedback from the Bank's engagements with consumer groups, **financial contracts, agreements and policy documents** are perceived to be too lengthy and complex. Efforts to encourage better informed and better protected consumers have therefore also focused on improving the communication of contractual rights and responsibilities under a financial contract to consumers through the use of plain language and simplified documentation. An initiative to adopt plain language for widely-used consumer financial

and insurance or takaful contracts commenced in early-2011, and will be implemented in stages. Plain language was introduced in life insurance contracts, with similar efforts underway for loan agreements. As part of this initiative, the Bank will undertake field tests to determine its impact on consumer decision-making and where appropriate, work with the industry to further improve documentation in a way that helps consumers better understand contractual rights and obligations when making financial decisions.

More competitive conditions in the financial sector led the Bank to devote significant resources during the year to pre-empting and addressing failures in the way financial products are sold or marketed to consumers. Given the increased volatility in financial markets, the Bank was mainly concerned that consumers need to be given clear and accurate information on the risks to which they were exposed, and that financial institutions were discharging responsibility to properly advise consumers on the suitability of products based on assessments of consumers' risk preferences and financial circumstances. Following a thematic review conducted by the Bank that focused on the sale of structured products, a number of banking institutions were required to further strengthen

internal oversight arrangements over the product origination, approval, sales and complaints handling processes to ensure that consumer conduct issues are sufficiently considered and addressed in accordance with the policies and guidelines issued by the Bank. Supervisory actions were also taken against insurers and takaful operators that were found to have mis-sold products. The insurers and takaful operators concerned were directed to withdraw misleading promotional materials, provide restitution to affected policy/certificate owners, effect the claw back of commission payments to errant intermediaries and suspend, terminate or retrain the intermediaries involved. Such actions saw premiums totalling RM53.7 million being refunded to more than 6,900 policy owners and 61 notices served on financial service providers requiring the withdrawal or modification of incomplete and/or inaccurate disclosures.

Initiatives were also undertaken in collaboration with industry associations to elevate the **level of service and efficiency** in the provision of financial services to consumers. This led to commitments by financial institutions to publish processing times for common financial services which were disclosed in customer service charters. Processes were also further simplified and streamlined across the industry for financing products available to small and medium enterprises with the launch of the “PARTNER” initiative in June 2011 by the Association of Banks in Malaysia. Moving forward, greater emphasis will be accorded towards raising the standards of professionalism and business conduct of intermediaries, to ensure intermediaries act with integrity and high ethical standards when dealing with consumers in the insurance and takaful industries.

PRESERVING THE INTEGRITY OF THE FINANCIAL SYSTEM

The Bank’s regulatory and supervisory activities also aim to reduce the scope for the regulated financial sector to be used for illegal purposes, including money laundering and financial crime. This is important to preserve the integrity of, and public confidence in, the financial system. Efforts in Malaysia have intensified in recent years to ensure the continued effectiveness of the legal infrastructure, systems and processes to promptly detect and prevent money laundering, terrorism financing and other illegal activities, in light of the more sophisticated and global nature of methods used to commit

financial crime. These initiatives contribute, and demonstrate Malaysia’s continued commitment, to global efforts to strengthen measures against financial crimes and reduce the illicit flows of funds.

In 2011, key legislative and regulatory reforms in the **money changing and remittance** industries were advanced with the passage of the Money Services Business Act (MSBA) in July 2011. This set in motion an intensive undertaking by the Bank to re-license all existing money changers and remittance service providers to ensure that those that remained in the industry are able and willing to implement effective controls to prevent these players from being used for illegal purposes. In support of this exercise, the Bank increased the scope and intensity of its fit and proper assessments of key responsible persons and its on-site reviews, focusing mainly on the quality of internal controls, recordkeeping and anti-money laundering and counter financing of terrorism (AML/CFT) compliance. On the whole, the Bank found significant room for improvement in the oversight, systems and controls of licensees, resulting in specific directions issued to many licensees to improve controls, particularly with respect to ensuring the complete and accurate recording of all transactions, observance of customer due diligence procedures and improvements in knowledge of AML/CFT requirements. As at end-2011, a total of 62 money changing licences were revoked for more serious failures to comply with various requirements under the law.

The MSBA which came into force on 1 December 2011 provides a single and uniform legal and regulatory framework for the money services business industry, which comprises the money changing, remittance and wholesale currency businesses. Along with the more intensive supervision of licensees, the successful implementation of the MSBA will also entail a focus on: (i) clarifying existing regulations to provide clearer guidance to the industry on the Bank’s expectations regarding effective measures to prevent financial crime; (ii) increasing the level and effectiveness of engagement with the industry to promote greater awareness and understanding of legal and regulatory requirements; (iii) strengthening industry arrangements, including the role of industry associations, to complement the Bank’s efforts to raise standards of professionalism in the industry; and (iv) improving the quality of the

Bank's intelligence on developments that increase the industry's exposure to financial crime. The Bank has consolidated its internal resources and established a dedicated Money Services Business Regulation Department to drive these priorities.

To further strengthen Malaysia's AML/CFT regime, efforts were also advanced to forge closer cooperation among international counterparts, notably in the sharing of financial intelligence and assistance in cross-border financial crime investigations

At the national level, the AML/CFT regime continued to be strengthened through the progressive implementation and enforcement of AML/CFT measures, supported by greater international cooperation. The Bank has observed strengthened compliance practices among financial institutions, especially an increased focus by the senior management of financial institutions on addressing compliance gaps and enhancing compliance capabilities through improvements in information technology systems and a higher commitment to training. Sustained engagements with relevant enforcement agencies and reporting institutions, including regular information sharing sessions and expanded outreach activities by the Bank, had an important role in aligning priorities and ensuring that the implementation of the National Strategic Plan reflected developments in the nature and profile of financial crime. The profile of continuing efforts at the national level to combat financial crime through a strong AML/CFT regime was raised further with the successful organisation of the Sixth AML/CFT Compliance Officers' Conference.

To further strengthen Malaysia's AML/CFT regime, efforts were also advanced to forge closer cooperation among international counterparts, notably in the sharing of financial intelligence and assistance in cross-border financial crime investigations. In 2011, Malaysia entered into two new Memoranda

of Understanding (MoUs) with the financial intelligence units of Papua New Guinea and Macau SAR of the People's Republic of China, bringing the MoUs in place so far to a total of 34. Such arrangements have significantly expedited financial investigations and increased the quality of intelligence gathered on entities of interest in cooperating countries.

SUPERVISORY CAPACITY AND COOPERATION

In light of the expansion of domestic financial groups across borders as well as the growing presence of foreign financial institutions operating in Malaysia, the Bank initiated and actively supported more structured approaches to cooperation with other supervisory authorities. In particular, the Bank moved to better leverage on the role of supervisory colleges in informing supervisory assessments, coordinating supervisory activities and generally promoting more coherent supervisory frameworks for the cross-border operations of financial institutions. During the year, the Bank hosted an inaugural meeting of the college of supervisors for a regionally-active Malaysian financial group, which included the relevant host supervisors. In its capacity as host supervisor, the Bank also participated in supervisory college meetings involving foreign financial institutions with operations in Malaysia. These discussions have enabled the Bank to form a more comprehensive view of the financial groups, which provided a deeper understanding of issues that concerned the authorities responsible for the supervision of entities within the group and how the group itself undertook group oversight and management of group-wide risks. Insights gained have also enabled the Bank to validate its assessments of the extent to which parent support and the centralisation of key functions present risks to regulated institutions in Malaysia. Moving forward, the Bank intends to organise more frequent supervisory colleges, in particular for the internationally-active Malaysian financial groups, while also leveraging on existing bilateral channels to share supervisory assessments and conduct joint examinations.

On the domestic front, the Bank continued to strengthen its cooperation with other domestic regulatory authorities. This includes

the coordination of supervisory activities with the Securities Commission on the supervision of investment banks and entities supervised by the Commission that are part of financial groups. The Bank and PIDM also completed a review of the Strategic Alliance Agreement (SAA) between both agencies to further strengthen the existing cooperative arrangements and to reflect the expanded scope of collaboration following the enactment of the Malaysia Deposit Insurance Corporation Act 2011. The enhanced SAA will, among others, provide for an enhanced scope and frequency of information sharing and improved coordination of intervention and resolution actions in respect of member institutions in line with the enhanced powers and responsibilities accorded to PIDM. The Bank expects that the scope and intensity of its cooperation with other authorities will continue to evolve to preserve an effective supervisory system as the nature of financial intermediation evolves. The Bank therefore places a high priority on building and maintaining effective relationships with other supervisory authorities, and will continue to review and ensure the relevance and effectiveness of existing cooperative arrangements.

Given the growing complexity of the task of supervision, both at a system-wide and institutional level, the Bank continued to invest significantly in strengthening its supervisory capacity. During the year, further enhancements were made to the existing supervisory training programmes to further enhance the ability of supervisors to identify, analyse and form appropriate judgements on risk issues. This has become increasingly important in an environment where risk can affect institutions in significantly different ways and to different degrees depending on an increasingly complex interplay of factors. Supervisory responses, in turn, need to be tailored accordingly so that these actions work effectively to address key risks facing an institution. The Bank's training

programmes for supervisors have increased focus on: (i) deepening supervisors' knowledge of business activities, inherent risks and risk management practices; (ii) delivering training in a more practical context to hone the ability of supervisors to react swiftly in specific circumstances, including through the greater use of simulations; and (iii) incorporating a better balance between supervisory and industry perspectives in the training content.

Moving forward, the Bank intends to organise more frequent supervisory colleges, in particular for the internationally-active Malaysian financial groups, while also leveraging on existing bilateral channels to share supervisory assessments and conduct joint examinations

A broader programme to enhance the Bank's supervisory resources, processes and tools is also underway to: (i) further strengthen the Bank's stress testing capabilities; (ii) improve the allocation of supervisory resources to make more optimal use of specialised knowledge residing within the Bank; (iii) enhance the efficiency and effectiveness of supervisory reporting through increased automation and more integrated surveillance systems; (iv) implement an improved framework for the prioritisation and supervision of consumer conduct issues (See white box 'Market Conduct Supervisory Approach'); and (v) strengthening the oversight of enforcement activities. The Bank expects to complete most of these initiatives in 2012.

Market Conduct Supervisory Approach

The global financial crisis highlighted the potential for market conduct issues to result in large-scale losses to consumers and cause widespread disruption to financial institutions and markets, as was evident in the mis-selling of mortgage products in the United States. Since then, there has been renewed regulatory focus on the importance of establishing effective oversight arrangements to ensure that financial institutions conduct business in a responsible manner, while empowering consumers to make informed financial decisions. This requires an appropriate regulatory framework and a credible supervisory process that is proportionate to the risks that consumers may face from improper business practices of financial service providers (FSPs).

The Bank regulates 298 FSPs offering a broad spectrum of products and services to retail consumers in the banking, insurance and takaful sectors. Given such a wide remit and the increasing importance of managing market conduct risk in a more competitive and complex environment, the Bank has strengthened its market conduct supervisory approach in 2011 with the aim of: (i) improving the prioritisation of market conduct issues and institutions for supervisory attention; and (ii) improving the Bank's engagements with FSPs, particularly with the institutions' senior management and board, on market conduct developments and concerns. These enhancements involve the principles that: (i) the board and senior management of FSPs must be primarily responsible for ensuring fair conduct towards consumers; and that (ii) consumers have an important role in protecting their own interests by using available avenues to seek information and redress, and to engage more actively with FSPs in making their financial decisions. The enhancements will enable the Bank to allocate its supervisory resources more optimally to key market conduct risks which have the highest potential for causing widespread detriment to consumers or a general loss of confidence in the financial system, and will also support the Bank's more forward-looking and preventive interventions.

A central piece of the enhanced supervisory approach involves changes in the manner in which the Bank obtains and analyses consumer information. Sources of information have been significantly expanded from mainly complaints and submissions of product information, to include a more regular cycle of direct feedback obtained from engagements with consumers, as well as observations from the Bank's assessments of the significant activities and control functions of institutions supervised by the Bank. Conversely, any material concerns identified through the Bank's market conduct reviews will form inputs to the Bank's prudential assessments to the extent that it increases an institution's potential exposures to financial losses due to legal or regulatory actions, loss of reputational goodwill, or collective behaviours of FSPs that contribute to heightened systemic risks as experienced during the subprime crisis. The Bank will also leverage on its presence throughout the country to obtain early indications of unhealthy practices in specific localities before they spread to other parts of the country. In addition, the Bank intends to review the scope and form of current complaints and product information reported to improve the quality and consistency of the data collected for purposes of its risk analysis.

The Bank will use this information to detect new trends in product innovations and distributions that carry inherent risks to consumers, and to support more complete cross-sectoral and industry-wide assessments of risks which form the basis of the Bank's thematic reviews. This will provide a deeper understanding of the factors that influence consumer behaviours. For this purpose, the Bank will begin work in 2012 to examine how consumers relate their decision-making to general or specific information provided on financial products and services, and the factors that promote or impede the ability of consumers to change FSPs. The Bank will also begin gathering more detailed information to understand the ways in which the interplay between collective actions of FSPs and consumer behavioural biases can increase systemic risks.

The Bank's strengthened analysis of market conduct risk will drive several other important changes in its supervisory approach. Thematic work, targeting specific products, services and practices identified through the Bank's risk analysis, will assume a more prominent role in the Bank's approach. This allows

for dealing more comprehensively across the industry with identified conduct risks, strong signalling effects of areas of concern to the Bank, and greater impact achieved from more targeted and coordinated interventions applied consistently across FSPs.

The Bank will complement its thematic work with the current review of market conduct practices of individual financial institutions. However, this will be based on an enhanced process for identifying institutions that will be subject to individual monitoring and that will attract greater supervisory attention. The Bank expects to complete a baseline assessment of the most active banking institutions, insurers and takaful operators in the retail market, based on considerations of size, profile of target market, product complexity and distribution channels, by mid-2013. This work has already started and is based on a more structured framework to assess how well an FSP is controlling its conduct risks. FSPs will be assessed against expectations of fair and responsible practices which are enumerated in various guidelines and circulars issued by the Bank across seven key areas: (i) product development and governance; (ii) transparency and disclosure of information; (iii) sales and marketing practices; (iv) after-sales support; (v) personal data protection; (vi) management and control of third party service providers; and (vii) advisory and redress channels. The baseline assessment will drive the intensity of the Bank's supervisory activities for such individual institutions. The Bank will maintain an ongoing review of all institutions identified for individual monitoring to track developments that may alter the baseline assessment and by extension, the level of supervisory intensity applied to them.

As highlighted earlier, a higher level of engagements with FSPs represents an important aspect of the Bank's enhanced supervisory approach. The implementation of a more consistent framework for supervisory assessments in the area of market conduct will enable the Bank to engage FSPs more constructively on its market conduct concerns. The assessments also aim to bring greater focus by the board and senior management on their critical role in promoting an institution-wide culture of ethical and responsible dealings in their conduct of business. This includes their role in setting remuneration policies, and ensuring that conduct issues are given appropriate attention in the institution's operational and risk management activities. The board and senior management will be accorded greater accountability for conduct failures. The Bank's interactions with FSPs will continue to be closely coordinated across the supervisory functions of the Bank to reduce duplicative burdens on FSPs. This will also promote greater focus on the growing interaction between the management of financial and market conduct risks.

