

2010

REGULATORY AND SUPERVISORY FRAMEWORK

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REGULATORY AND SUPERVISORY FRAMEWORK

INTRODUCTION

Bank Negara Malaysia's regulatory framework and supervisory oversight continued to support the overall development of the domestic financial system and financial system stability in 2010. With volatility in global financial markets remaining elevated and more intense domestic competition, the Bank's regulatory and supervisory activities remained focused on promoting sound risk management and effective board oversight functions in financial institutions to ensure that risk-taking activities are prudent, sustainable and subject to effective controls. This was supported by rigorous and sustained stress tests by both the Bank and financial institutions, and the ramping up of the Bank's market conduct surveillance and supervisory activities in the retail segment of the financial system. The Islamic financial system was also further strengthened, with the development of a more robust solvency framework and Shariah governance standards for Islamic banks and takaful operators.

As financial conglomeration and convergence continued to shape the domestic financial landscape, policy initiatives also served to bring about greater consistency in the treatment of similar risks between the banking and insurance sectors, and between the conventional and Islamic financial sectors. This builds on the Bank's significant cumulative efforts over the years to develop a better understanding of the underlying business and

risk models in the various financial sub-sectors, and the interlinkages between them.

The Bank's regulatory and supervisory activities remained focused on promoting sound risk management and effective board oversight functions in financial institutions

INTERNATIONAL AND DOMESTIC REGULATORY DEVELOPMENTS

International regulatory initiatives in response to the global financial crisis progressed significantly in 2010 with agreement reached by the Basel Committee on Banking Supervision (BCBS) in September 2010 on key elements of the reform package (better known as Basel III), mainly in respect of capital adequacy and liquidity standards.

Quantitative assessments carried out by the BCBS on the financial and economic impact, including the long-run economic benefits and costs, of the reform proposals under Basel III suggest that banks should be able to meet the higher capital requirements through relatively modest earnings retention and capital raising, while remaining supportive of lending to the economy. This is affirmed by assessments carried out by the Bank on the impact of the new capital measures on banking institutions as illustrated in Table 3.1.

Table 3.1

Impact Assessment of Global Reforms on Capital on Banking Institutions

	Common Equity Ratio	Tier-1 Capital Ratio	Total Capital Ratio	Leverage Ratio
Minimum requirement	4.5%	6.0%	8.0%	3.0%
Conservation buffer	2.5%	2.5%	2.5%	–
Minimum requirement plus conservation buffer	7.0%	8.5%	10.5%	–
Current Basel II position	12.3%	13.0%	14.8%	–
Estimated Basel III position	9.5%	11.1%	14.8%	5.9%

Source: Bank Negara Malaysia and internal computation

The liquidity standards however will likely pose greater challenges for banks in Malaysia given the structure of the domestic funding market. While banks in Malaysia are already accustomed to complying with liquidity requirements that are conceptually consistent with the Liquidity Coverage Ratio, the dominant role of the Employees Provident Fund in mobilising domestic savings and the lack of sufficient eligible liquid assets will substantially constrain banks' ability to capture more stable retail deposits and bolster their liquidity buffers in order to comply with the new liquidity standards under Basel III. Further details on the proposed reforms and their implications can be found in the box article "Basel III and its Potential Implications on Malaysia and the Financial System".

The Bank intends during the course of 2011 to issue an implementation strategy for the incorporation of the enhanced capital and liquidity rules into the domestic regulatory framework. This will take into account, where appropriate, the need to provide more granular parameters under the new rules to reflect the specific characteristics of the domestic market and relevant transitioning arrangements. Work will also be directed towards operationalising an objective and robust framework for the implementation of the counter-cyclical capital buffers required under Basel III.

Global initiatives to strengthen the resilience of the Islamic financial system were also taken forward during the year. In April 2010, the Task Force on Islamic Finance and Global Financial Stability (a joint collaboration between the Islamic Development Bank and the Islamic Financial Services Board (IFSB)) published the Islamic Finance and Global Financial Stability Report that examines in greater depth the conceptual elements inherent in Islamic finance and identifies priorities for the development of an international Islamic financial system that will further enhance prospects for greater global financial stability. Drawing on lessons from the recent crisis which highlight the fragilities inherent in the global financial system, the report identified eight key building blocks to provide a solid foundation for a sound and resilient Islamic financial system in the more challenging global environment.

These building blocks include: (i) the global implementation of IFSB prudential

standards; (ii) the development of a systemic liquidity management infrastructure; (iii) the establishment of strong financial safety nets; (iv) the institutionalisation of an effective crisis management and resolution framework; (v) enhancements to the accounting, auditing and disclosure standards for Islamic financial institutions as well as governance arrangements; (vi) the development of an effective macroprudential surveillance framework; (vii) strengthening of the rating processes for Islamic financial institutions and instruments; and (viii) increased intensity in capacity building and talent development to keep pace with the rapid growth of Islamic finance. The development of these building blocks in Malaysia is already well-advanced as a result of concerted efforts to promote the orderly expansion of Islamic finance in parallel with the conventional financial system over the last decade. The focus going forward will be to reinforce these foundations through the promotion of globally consistent applications and practices. In addition, further efforts are needed to develop more robust rating processes for Islamic financial institutions in order to support its rapid growth and expansion.

The Bank intends during the course of 2011 to issue an implementation strategy for the incorporation of the enhanced capital and liquidity rules into the domestic regulatory framework

Following a key recommendation of the report, the Islamic Financial Stability Forum (IFSF) was established in April 2010 to provide a global platform for cross-border cooperation and dialogue with a view to promote the effective and timely exchange of information on developments in the Islamic financial system and their implications for national and global financial stability. In addition, the IFSF is also intended to support the coordinated implementation of policies to prevent, contain and manage emerging risks in Islamic finance.

The review of the international financial reporting standards also progressed during the year. In October 2010, the International Accounting Standards Board (IASB) completed

Basel III and its Potential Implications on Malaysia and the Financial System

Basel III and the global financial reforms

In September 2010, the Basel Committee on Banking Supervision (BCBS) endorsed a package of reforms to strengthen global capital standards and introduce global standards for liquidity – now collectively referred to as Basel III. The reforms which represent the core components of the global financial reform agenda aim to improve the banking sector's ability to absorb financial and economic shocks, thus reducing the risk of spillover from the financial sector to the real economy. This article discusses the implementation of the Basel III capital and liquidity reforms for banking institutions in Malaysia.

Table 1

Elements of the Basel III reform package

Areas	Reform measures
Capital	<ul style="list-style-type: none"> • Raise the quality, consistency and transparency of the capital base so that banks are better able to absorb losses on both a going concern and a gone concern basis. • Strengthen capital requirements for counterparty credit risk exposures arising from derivatives and securities financing activities. • Raise the level of minimum capital requirements, particularly for Tier-1 capital and common equity. • Incentivise the conservation of capital through the build-up of capital buffers above the minimum requirement which can be drawn down by individual banks as losses are incurred. • Promote the build-up of counter-cyclical capital buffers at the system level to protect the banking sector from periods of excessive credit growth and thus maintain the flow of credit in the economy during a downturn. • Introduce a non-risk-based leverage ratio to reinforce risk-based requirements and constrain the build-up of leverage, thus mitigating the effects of excessive deleveraging in the banking system during distressed periods.
Liquidity	<ul style="list-style-type: none"> • Introduce a Liquidity Coverage Ratio (LCR) to ensure that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting a month. • Introduce a Net Stable Funding Ratio (NSFR) to promote resilience over a longer-term horizon by creating incentives for banks to fund activities with more stable sources of funding on an ongoing basis.

Implementation of Basel III in Malaysia

Banking institutions in Malaysia will be able to transition into Basel III from a position of strength owing to the extensive reform initiatives undertaken by the Bank and the industry following the Asian financial crisis. All major elements of the Basel II capital framework – including the Internal Ratings-Based approach for credit risk as well as the Pillar 2 and Pillar 3 components – have been put in place. Explicit liquidity requirements which ensure that banking institutions hold adequate high quality liquid resources to survive acute stress situations, consistent with the objectives of the LCR introduced by the BCBS, have also been in place for over a decade. With minimal exposures to complex and high-risk off-balance sheet activities which are mainly targeted by the reforms, strong starting capital positions (common equity and reserves currently contribute towards approximately 70% of the banking system's total capital) and leverage levels in line with that permitted under Basel III (the banking system leverage is 5.9%, against the minimum 3%), the need for substantial structural adjustments in the Malaysian banking system will be less significant than those of advanced economies.

The implementation of Basel III in Malaysia will further reinforce these foundations, while reducing procyclicality and contagion within the financial system. With their greater regional presence, Malaysian financial institutions can also expect to be held up to greater scrutiny by investors, analysts and market participants in respect of their compliance to global standards. For these reasons, the Bank has already initiated work to develop strategies for Basel III implementation in Malaysia and will begin consultations with industry players in 2011 on specific enhancements to the existing capital and liquidity frameworks

required to give effect to the requirements of the global reform package. The sequencing and timelines of implementation of these enhancements will also be determined as part of this process.

While the BCBS has outlined an extended time frame until 2018 for the implementation of the new requirements to provide continued support for the global economic recovery process, the positive outlook maintained for Malaysia as well as the strong capital positions of banking institutions allow considerable flexibility for certain elements of the package to be implemented on an accelerated basis. Any decision to fast-track implementation in Malaysia will consider the need to ensure that the standards are implemented at a speed and manner that does not disproportionately impact individual components of the financial system or sectors of the economy. The Bank also aims to coordinate implementation with other countries within the region to avoid any material market distortions. However, this will be carefully weighed against the clear benefits of moving the domestic banking system to a higher degree of resilience in a timely fashion.

Implications on the economy and the financial intermediation process

The main concerns expressed at the international level with Basel III have been the potential impact of the reforms on the cost and availability of financial services due to the need for banks to realign business strategies and restructure balance sheets, including through the build-up of larger liquidity buffers, and the raising of longer-term debt and high quality capital. The extended implementation time frame provided by the BCBS serves to mitigate the risk of resulting constrictions to the supply of credit particularly given the fragile pace and extent of global economic recovery. Based on a joint assessment by the Financial Stability Board and the BCBS released in 2010, given the reasonable implementation time frame, the transition to stronger capital and liquidity standards will likely only have a modest impact on global economic growth. It is estimated that if higher capital requirements are phased in, the annual growth rate in gross domestic product would be reduced by an average of only 0.04% over a period of four and a half years.

In Malaysia, banking institutions are already largely operating at capital adequacy and leverage levels consistent with the requirements and targets set under Basel III, thus the impact of the new capital standards on the real economy will likely be modest. Preliminary assessments by the Bank indicate that the current reported common equity ratio of the banking system, adjusted for Basel III requirements, would be approximately 9.5%, well above the minimum common equity ratio of 7% (including the capital conservation buffer). Internal capital management strategies by banking institutions to maintain comfortable buffers over the new regulatory minimums are also expected to be easily met through the retention of earnings, obviating the need for large-scale capital raising activity. This is supported by the prudent earnings retention practices of banking institutions in Malaysia over the last decade, with 57.5% of new capital of banking institutions attributable to increases in reserves and retained earnings.

Meeting the Basel III liquidity requirements will however be considerably more challenging. Based on self-assessments conducted by a number of banking institutions in 2010, the LCR under Basel III for most banking institutions is expected to range between 60-80% (against the required 100%). Reflecting the higher assumed sensitivity of wholesale funding to changes in interest rates and perceived credit risk, the new liquidity rules apply run-off rates on wholesale funding that are significantly higher than for retail deposits, and higher than that observed by distressed banking institutions in Malaysia during the Asian financial crisis. While this may incentivise banking institutions to source more stable retail deposit funding, the ability of the Malaysian banking sector as a whole to mobilise greater amounts of retail deposits in the short run is constrained by the dominance of other pensions and investment schemes (notably the Employees Provident Fund and Permodalan Nasional Berhad) that account for a significant share of household savings. Perversely, heightened competition for retail deposits may also result in banking institutions offering and potentially mis-selling complex and opaque structured investment products which may not be suitable for the general public. While other avenues such as the issuance of long-term senior debt exist for banking institutions to shore up their liquidity positions and to diversify their funding sources, this is likely to be more costly than raising retail deposits.

In view of the wider implications of the Basel III liquidity rules, the Bank intends to use the observation period¹ provided by the BCBS to perform further analyses of the implications of the standards for domestic financial markets and credit extension. This will leverage on data currently submitted to the Bank under the existing Liquidity Framework and additional data as may be required to facilitate the Bank's analyses. A key focus will be on monitoring the behaviour of wholesale funding sources. The outcome of this assessment will form the approach to the implementation of the LCR in Malaysia.

The need for banking institutions to shore up their capital and liquidity positions may however encourage the development of new classes of financial instruments in Malaysia. This includes covered bonds which qualify as liquid assets under Basel III and new forms of hybrid instruments which meet the more stringent criteria set by the BCBS, including contingent capital. While these instruments have been held out as cost-effective means for banks to meet the standards, they will require supporting legal, regulatory and institutional arrangements to be put in place to ensure that these instruments will perform as envisaged in a crisis, and gain acceptance among market participants. As an example, institutional investors will have to also evaluate the extent to which their investment objectives can continue to be met through investments in debt instruments that convert more easily to equity, and this in turn would depend on the defined triggers for conversion applied to such instruments. The Bank will continue its engagement with market participants and other relevant authorities on these developments during the observation period, with early attention given towards the prospects of developing a covered bond market which could qualify under Basel III.

Remaining concerns

Two other areas of the reform package will require a more cautious approach to implementation. The first relates to the way in which total exposures are determined for the purpose of complying with the leverage ratio which requires banking institutions to hold the same amount of capital for a majority of on- and off-balance sheet exposures regardless of their inherent risks. The Bank shares concerns expressed by a number of countries that this could inappropriately disincentivise the provision of credit to low-risk and economically productive activities, such as trade financing. The second concerns the strong incentives created by the NSFR to avoid long-term financing which would affect the banking system's critical role in maturity transformation. Given the potential for unintended consequences which can harm the broader economy, particularly emerging and highly open economies, it is crucial that a careful appraisal be made of the likely effects of these measures during the observation period and appropriate adjustments incorporated prior to their full implementation. In this regard, the Bank welcomes the commitment by the BCBS to use the observation period to assess whether the proposed design and calibration of these measures are appropriate to achieve their intended objectives while avoiding economic dislocation.

Conclusion

On balance, the implementation of Basel III is expected to deliver long-term benefits to the overall economy and financial system, with a much strengthened banking system operating as its core. With a more resilient banking system, the likelihood and severity of future banking crises will be reduced, as will the need for large-scale government interventions to support the economy and to stabilise the financial system during crises. Moreover, elements of the reform package that reduce procyclicality and promote counter-cyclical buffers will ensure that the banking sector has the capacity to support lending activities during economic downturns, thus reducing the amplitude of the business cycle. On issues that remain open in respect of specific components of the reform package, the observation period will be critical to allow a more complete assessment of the proposals and refinements to be made as appropriate to address any unintended consequences.

¹ For the LCR, the BCBS has provided for an observation period beginning 2011 to end-2014 where national supervisors and the BCBS will monitor the impact of the standards on the financial systems and economies throughout the world prior to its full implementation in 2015.

the classification and measurement phase of its project to replace the existing international accounting standards for financial instruments, International Accounting Standard (IAS) 39. This marked a significant step in international efforts to reduce the complexity of accounting standards for financial instruments. The new requirements will make it easier for users of financial statements to assess the amounts, timing and uncertainty of cash flows arising from financial assets by aligning the measurement of such assets with the way the entity manages these assets (its 'business model') and with their contractual cash flow characteristics. Limited changes were also made to the measurement of financial liabilities to address widely expressed concerns with earlier provisions which allowed companies to record gains as a result of a deterioration in their own credit risk. The second and third phases of the IAS 39 replacement project that addresses accounting for the impairment of financial assets and hedge accounting are scheduled to be completed in June 2011. Proposed measurement standards on accounting for insurance contracts were also issued by the IASB in July 2010. The proposals would provide a more consistent basis of accounting for insurance contracts, thus enhancing comparability across entities, jurisdictions and capital markets. These standards are at a consultation phase in Malaysia and have been subject to a sustained engagement programme by the Bank and the Malaysian Accounting Standards Board (MASB) with the industry to prepare for their adoption while contributing meaningfully to the international standard setting process. Given Malaysia's commitment towards convergence with international financial reporting standards, it is important that financial institutions leverage on these engagements to understand and assess the implications of the new standards for policies, systems and processes within their organisations.

The following sections provide greater details on key developments in the domestic regulatory and legal framework in 2010.

Capital adequacy

Following two years of intense efforts by banking institutions to enhance their internal rating models and processes, 11 banking institutions completed the transition to the Internal Ratings-Based (IRB) approach for

credit risk under Basel II in 2010. With their transition, all banks in Malaysia now comply with the Basel II capital standards.

A significant benefit from the adoption by banking institutions of more advanced approaches to regulatory capital under Basel II has been the corresponding improvements made to internal processes and information technology systems which have promoted a deeper and more complete understanding among senior management about the risk drivers behind the bank's business strategies. This allows for more informed decisions, better risk management and the ability to respond more effectively to changes in market conditions.

In December 2010, the Bank issued Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP) which set out the Bank's approach to Pillar 2 (Supervisory Review Process). Under Pillar 2, banking institutions are required to assess the adequacy of capital relative to their overall risk profile, including risks which are not covered or fully captured under Pillar 1 (such as interest rate risk in the banking book and credit concentration risk). The ICAAP assessments overlay the minimum capital requirements determined under Pillar 1, with banks required to maintain capital levels above the Pillar 1 standards consistent with their individual risk profiles and objectives. The Bank's current supervisory process and practices for reviewing the capital adequacy of banks under the risk-based supervisory framework (RBSF) are broadly consistent with Pillar 2 principles. The ICAAP assessments required under Pillar 2 are therefore expected to complement this process in two particular respects:

- by providing additional input from a bank's own internal processes to better inform the Bank's assessment of the institution's inherent risks under the RBSF; and
- by encouraging the integration of a bank's capital management practices with its business processes, thus strengthening the link between the Bank's assessment of an institution's significant activities and its capital adequacy.

As part of the ICAAP, banking institutions are expected to develop appropriate strategies for maintaining capital at a level consistent with the institution's risk profile. The Bank's supervisory activities in 2011 will be directed

at reviewing and monitoring the progress of banking institutions' Pillar 2 initiatives and understanding the approaches used by banks to allocate capital to key business risks. Particular emphasis will be given to the extent to which banks integrate their ICAAPs into their internal processes for business planning and forecasting, risk mitigation, governance and control, pricing and performance management. In anticipation of the implementation of the higher capital standards, including additional capital conservation buffers under Basel III, supervisory reviews of banking institutions' ICAAPs will also consider relevant strategies by banks to meet higher future capital levels, including through reasonable earnings retention and capital raising policies. Greater scrutiny will also be undertaken of banks' capital disclosures under Pillar 3, which were further enhanced during the year for Islamic banks and banking institutions adopting the IRB approach.

The Bank's supervisory activities in 2011 will be directed at reviewing and monitoring the progress of banking institutions' Pillar 2 initiatives and understanding the approaches used by banks to allocate capital to key business risks

The Risk-Based Capital (RBC) Framework for insurers continued to provide a sound foundation for the continuous strengthening of insurers' capital positions. As at end-December 2010, the industry-wide capital adequacy ratio stood at 224.6%. Improvements continued to be observed in insurers' risk management practices, with the development and wider adoption of more systematic approaches to assessing and managing risk exposures. The Bank intends to update the RBC Framework in 2011 to take into account international developments towards establishing a globally consistent solvency framework for insurers which is being advanced by the International Association of Insurance Supervisors (IAIS), lessons from the crisis and developments in accounting standards for insurance contracts. Specific areas under

consideration for review include the valuation methodology for life insurance liabilities, recognition of reinsurance arrangements, and the capital definition. During the year, the Bank also withdrew the temporary flexibility accorded to life insurers for the valuation of certain life insurance liabilities introduced in response to developments arising from the global financial crisis. Life insurers were able to adjust to the withdrawal with no material impact to their capital positions, demonstrating their continued resilience.

The Bank has further detailed the specific components of the Risk-Based Capital Framework for takaful operators (RBCT), building on the conceptual parameters established for RBCT in 2009. This includes the determination of the capital adequacy formula and specific capital risk charges which reflect the fundamental differences between the business models that underpin the insurance and takaful industries. The RBCT additionally addresses the need for takaful operators to adhere to Shariah requirements. Consultations with the industry on the RBCT and impact assessments will commence in the second quarter of 2011.

Corporate governance

As part of continuing efforts by the Bank to promote more effective and engaged boards of financial institutions, further clarity was provided by the Bank on the position of board members with executive roles within a group context. This follows and further entrenches the essential principle of preserving a clear separation between the oversight and management functions within a financial institution, in particular by ensuring an adequate balance of members on the board who are truly independent from management. More specifically, an individual employed by a financial group who assumes management or control responsibilities within the group, shall generally be regarded as an executive director of the financial institution. Such an individual may not be appointed Chairman of the board of the financial institution. Where more than two executive members are represented on the board, the Bank may direct financial institutions to put in place compensating measures which may include appointing additional independent directors on the board to strengthen the independence of the board from management.

The issuance of the Guidelines on Fit and Proper for Key Responsible Persons in March 2011 will

further complement the corporate governance framework. The guidelines require financial institutions to establish policies and processes for assessments of the fitness and propriety of key persons in responsible positions within a financial institution on an ongoing basis, including members of senior management, and persons primarily responsible for key control functions (which includes appointed actuaries). The guidelines also address the factors that should be considered in determining a responsible person's fitness and propriety, and actions for dealing with persons found to be no longer fit and proper.

The issuance of the Guidelines on Fit and Proper for Key Responsible Persons in March 2011 will further complement the corporate governance framework

On Islamic finance, the Bank finalised and issued the Shariah Governance Framework for Islamic Financial Institutions (the Framework) in October 2010 to strengthen the accountability and responsibilities of the board, the Shariah Committee and the management of Islamic financial institutions in relation to Shariah matters. The Framework supports more effective Shariah audits and Shariah compliance and research functions within Islamic financial institutions. In ensuring that the operations and business activities of the Islamic financial institutions are consistent with Shariah principles at all times, the role of the Shariah Committee has been elevated from that of an advisory nature to one with a higher degree of authority and clear accountability for decisions on Shariah matters. The Framework takes effect from 1 January 2011.

The Financial Institutions Directors' Education (FIDE) programme continued to serve as the core training programme for directors of financial institutions, with over 200 directors of banking institutions, insurers and takaful operators having completed the core programme since its launch in November 2008. Further enhancements were made to the programme during the year, supported by existing and new faculty members who are experts in the field of governance and risk management. The

Information Technology (IT) Governance and Risk Management Programme for directors was introduced from September 2010, bringing the total complement of specialised programmes offered together with the core programme to five.

The role of the Shariah Committee has been elevated from that of an advisory nature to one with a higher degree of authority and clear accountability for decisions on Shariah matters

Further enhancements to the FIDE programme which are planned for 2011 include new programmes for the boards of insurance companies and additional technical complements in areas such as corporate finance, strategic marketing and cross-border investments. FIDE is managed and delivered by the International Centre for Leadership in Finance (ICLIF) under its newly formed Governance Centre. Further details are provided in the box article "Financial Institutions Directors' Education under the ICLIF Leadership and Governance Centre".

Financial reporting standards

For financial years beginning 1 January 2010, financial institutions have been required to adopt Financial Reporting Standard (FRS) 139 Financial Instruments: Recognition and Measurement in the accounting for financial instruments and impairment of loans/financing. The majority of banking institutions applied the transitional provision allowed by the Bank for the determination of collective impairment provisions pending the finalisation of the new impairment standard which is currently under review by the IASB. With the new basis adopted by banks for impairment under FRS 139, a key supervisory focus has been on ensuring that loss estimates by banks are determined at a sufficiently prudent level to absorb the inherent credit losses in the loan portfolio. An important benefit observed from the adoption of FRS 139 has been the corresponding improvements made to the credit review process of loans that are individually assessed for impairment. As a result, impairment provisions increased, but were more reflective of a broader range of both quantitative and qualitative

Financial Institutions Directors' Education under the ICLIF Leadership and Governance Centre

The Financial Institutions Directors' Education (FIDE) programme, introduced by the Bank and the Malaysia Deposit Insurance Corporation (PIDM) in November 2008, is now being offered under the International Centre for Leadership in Finance (ICLIF) as of September 2010. FIDE was developed with the aim of promoting high-impact boards in financial institutions by strengthening board competencies in dealing with corporate governance, risk management and strategic issues in the financial sector. Emphasis is placed on important current issues confronting the financial industry, drawing from the Bank's supervisory observations and global and domestic developments affecting financial institutions. Directors will have the opportunity to debate these issues at an intellectual level and examine their practical implications in the context of the environment they operate in. This is achieved through the extensive use of case studies and simulations developed based on real experiences in the financial sector. FIDE thus aims to equip directors with practical tools and knowledge to provide effective oversight on managements of financial institutions.

Over the two years since its launch, the FIDE programme has been continuously refined and enhanced to reinforce its key strengths, namely:

- (i) a unique and singular focus on governance within financial institutions which allows in-depth discussions to take place among like-minded directors on specific issues that they face on the board. It also facilitates the customisation of key modules such as that on risk management to address the different business considerations in banking, insurance and Islamic finance;
- (ii) the pooling of the extensive wealth of knowledge and practical insights of experienced directors who participate in the programme to provide an environment where directors learn from each other. This experience is carried over outside the classroom through ongoing support and tools provided to directors to maintain contact after the programme;
- (iii) a strong and diverse faculty consisting of thought leaders and practitioners drawn from various backgrounds, with vast experience in financial services and adult learning; and
- (iv) the extensive involvement of regulators and supervisors in providing content input and reinforcing the lessons learnt through the supervisory interactions with financial institutions. This ensures that education is translated into better board practices and preserves a strong link between the programme and desired financial stability outcomes.

The FIDE initiative which started with the core modular-based programme has also been expanded in response to strong interest from financial institutions' directors for further training. FIDE now provides, in addition to the core programme, training in a range of specialised and technical areas to cater for specific board roles (such as the audit committee, risk management committee and nominating committee) and the interest among directors to deepen their knowledge of particular aspects of their business (e.g. in information technology and Islamic finance). Since 2010, programmes were also provided for new directors to enhance their knowledge of basic banking and insurance business. FIDE is also supplemented by a series of talks and special lectures by renowned speakers and leading industry experts on topical issues which enable directors to keep abreast with current developments.

To date, more than 230 Malaysian financial institutions' directors have benefited from the FIDE programme, resulting in a significant strengthening of boardroom practices in the financial institutions. FIDE's success as well as a heightened awareness globally of the importance of governance and the need for effective boards to strengthen the resilience of financial institutions

and promote long-term financial stability has attracted increasing interest from directors of financial institutions from around the region to participate in the programme. In response to this interest and as part of efforts to deepen cross-border cooperation in promoting financial stability, FIDE's outreach has been expanded to make the programmes available to directors of financial institutions in the Asia Pacific, Middle East and African regions beginning from 2011. ICLIF will serve as the platform to manage, adapt and deliver the FIDE programme offering to the regions. As part of this move, ICLIF has established a Governance Centre and was renamed the ICLIF Leadership and Governance Centre to reflect its wider mandate.

The move will enable FIDE to leverage on ICLIF's core strength in developing leadership competencies to further enrich FIDE and complement FIDE's faculty with leadership and governance experts in ICLIF from world leading institutions. FIDE's commitment to lifelong learning and building an effective support network for directors of financial institutions will also be preserved and further reinforced. There will be enlarged resources dedicated under ICLIF to research, the development of new programmes and case studies, and the provision of a broad range of advisory services for directors.

To ensure the practical relevance of the programme to the industry and to take into account changes in the financial landscape, there is continuous interface with the industry so as to provide leading edge education for directors in the financial sector. Further information on FIDE can be obtained from its website at www.fide.org.my.



credit information used in banks' provisioning methodologies. To minimise the divergence in practice under more principle-based FRSs which would reduce the comparability of financial statements between financial institutions, additional guidance was issued to individual institutions to promote more consistent applications, particularly in defining impaired loans and providing for non-performing loans which are individually insignificant.

Financial reporting practices for the insurance and takaful industries were also brought closer in line with applicable accounting standards, namely the FRS 139 and FRS 4 Insurance Contracts, with amendments to the existing Guidelines on Financial Reporting for Insurers and the Guidelines on Financial Reporting for Takaful Operators issued by the Bank in July 2010. Based on prudential considerations and given the ongoing policy consultations on the measurement and presentation of the insurance contracts at the international level which may result in substantive changes to FRS 4, two departures from FRS were preserved. These are the requirement that life insurance contracts be presented as liabilities (instead of equity) in the insurers' statement of financial position and the non-deferment of acquisition costs for life insurers whereby such costs would continue to be accounted for as and when they are incurred. The guidelines also specify expectations that must be met by insurers in the use of the fair value option for financial assets as well as additional guidance on the measurement of *qard* and impairment methodologies to promote consistency and comparability among takaful operators.

Other aspects of the prudential framework for Islamic finance

In the Islamic banking industry, developments in the prudential regulatory framework responded to the increased scale and diversity of Islamic banking activities. The Guidelines on Property Development and Property Investment Activities by Islamic banks, first issued in 2007, were revised in March 2010 to strengthen the Bank's expectations in relation to requirements for Islamic banks to have in place a robust governance framework and effective internal controls that promote prudent business practices. While involvement in property development and property investment activities by Islamic banks in Malaysia is currently not significant, regulatory measures have been

progressively put in place to mitigate the risks arising from the cyclical effects of the real estate market and activities related to asset-based financing operations of Islamic banks. The enhanced supervisory expectations include requirements for key functions to be installed by Islamic banks to support sound technical assessments, research and asset valuations in their property development and investment units.

A review of the Rate of Return (ROR) framework was also undertaken to strengthen the operational aspects of the framework in keeping with the enlarged and diversified scope of Islamic banking institutions' business, which includes real estate and property investment, leasing, structured products and equity-based transactions. The ROR framework protects the interests of investment account holders under contractual relationships with Islamic banks, particularly in respect of *mudharabah* contracts. The Bank will issue a concept paper on proposed revisions to the framework in the third quarter of 2011. The revisions will cover, among other things, strengthened requirements for segregation in the management of *mudharabah* and other types of funds in order to prevent the commingling of returns and losses between these funds.

In connection with the review of the ROR framework, the Bank conducted a separate consultation with the industry on proposals to strengthen governance and transparency in the application of profit equalisation reserves (PER) by Islamic banking institutions. PER is an important tool in managing displaced commercial risk, which refers to the risk that Islamic banking institutions will have to forgo part of its share of profit in order to provide market rate of returns to investment account holders. In addition to further detailing the Bank's supervisory expectations in the management of PER, the review also sought to clarify the accounting treatment for PER within the framework of approved FRS established by the MASB and the regulatory capital treatment applicable to PER.

The regulatory framework for the takaful industry was also substantially strengthened in 2010. A central component of the regulatory framework was completed with the issuance of the Guidelines on Takaful Operational Framework (TOF) in December 2010. The TOF addresses requirements for the establishment

and management of takaful funds that include principles relating to asset, liability and surplus management, as well as the rectification of deficits in the takaful funds. It also prescribes broad disclosure requirements to enhance transparency in takaful operations. Consistent with the Bank's approach in regulating Islamic financial services, strict requirements are upheld in respect of Shariah compliance in takaful operations while allowing flexibility for individual takaful operators to decide the appropriate Shariah contracts to apply in their operations, as approved by their respective Shariah committees. The TOF is supported by Guidelines on Valuations for Takaful Liabilities which were issued in December 2010 to ensure adequate provisions (or reserves) for takaful benefits that are commensurate with the product features and underlying risks. The TOF comes into effect on 1 October 2011.

Consumer and market conduct

Consumer and market conduct issues have drawn significant attention globally in the aftermath of the global financial crisis. While the focus of the Bank's regulatory and supervisory activities in the area of market conduct were largely driven by domestic considerations, international developments served to inform the Bank's work, particularly in the retail financing segment. With intense competition in the retail segment showing no signs of abating during the year, the Bank heightened its scrutiny of the practices of financial institutions in acquiring new customers. In general, the Bank found that banking institutions observed prudent underwriting standards, but varied considerably in the rigour of standards applied for assessing the suitability of products given the needs and circumstances of prospective customers to whom the products were offered. Some practices observed also contributed towards inappropriately increasing the debt burden borne by consumers against their long-term interests. As a result of these observations, a concept paper on the Conduct of Business for Retail Financing and a revised Credit Card Guidelines were issued to enhance the protection afforded to consumers and promote responsible credit behaviours among financial institutions. Given the nature and intensity of competition in the retail space which can work against the interests of consumers, the Bank has taken a more prescriptive approach in these guidelines in order to safeguard the interests of

more vulnerable consumers. The Bank expects to finalise these guidelines in the second quarter of 2011 after resolving implementation issues identified during the consultation process.

During the year, the Bank also initiated a review of existing guidelines on late payment charges by Islamic banks. The proposed revisions which were exposed to the industry in September 2010 include enhanced methodologies to calculate late payment charges and improved governing processes for administering the *gharamah* (penalty) and *ta'widh* (compensation) payments. The concept paper also addresses minimum standards for the financial reporting and disclosures of late payment charges as well as appropriate appeal mechanisms for the consideration of cases of late payments with mitigating circumstances. The Bank has further outlined proposals to provide for more equitable mechanisms in the granting of *ibra'* (rebate) by Islamic banking institutions. These aim to address issues relating to the inconsistency in practices and application in terms of the eligibility of *ibra'* for customers in sale-based contracts (such as *murabahah* and *bai' bithaman ajil*).

In the area of investor protection, the Bank in consultation with the Securities Commission Malaysia, issued the Guidelines on Investor Protection in December 2010 which are applicable to financial institutions carrying out permitted capital market activities that are deemed as 'registered persons' under the Capital Markets and Services Act 2007 (CMSA). The guidelines provide for the application of all relevant investor protection provisions under the CMSA to registered persons and ensure that the employees carrying out permitted capital market activities on their behalf are fit and proper, thus affording equivalent standards of investor protection to customers of financial institutions as that provided to customers of other capital market intermediaries.

In the insurance and takaful sectors, substantive revisions were made to the investment-linked guidelines to provide insurers and takaful operators with greater flexibility in the design and offering of investment-linked insurance and takaful products. This acknowledges the increased demand for such products since their introduction to the Malaysian market more than a decade ago and the enhanced capacity and sophistication of consumers to manage their

finances using a broad array of savings and investment plans combined with life protection. The added flexibility provided to insurers and takaful operators is accompanied by enhanced disclosures and strengthened internal oversight arrangements for the management and control of investment-linked business.

The industry associations continued to play an important role in fostering fair market practices. The Life Insurance Association of Malaysia (LIAM) is close to finalising an industry framework for treating customers fairly in the provision of life insurance services, building on principles for the fair treatment of consumers under the guidelines issued by the Bank. This is expected to guide life insurers in the operationalisation of regulatory requirements for treating customers fairly. In addition, LIAM members passed a resolution to disallow insurers from using the doctrine of privity of contract to deny the rights of individual borrowers/life assured to bring actions against insurers under individual and group mortgage reducing term assurance policy contracts between insurers and financial institutions. In the general insurance sector, Persatuan Insurans Am Malaysia is currently working with the relevant stakeholders involved in motor insurance claims to improve the efficiency of claims settlement practices. Initiatives that are being advanced include measures to curb unreasonable practices by insurers in imposing across-the-board trade discounts on repair estimates, improving the professionalism of panel repairers through a 'tiering system' as well as reducing subjectivity in the determination of the market value of vehicles. These initiatives will contribute towards improving the quality of motor repairs, the time taken to settle claims, and the overall public perception of the insurance industry.

Reforms to financial services legislation

Proposed legislative changes to amalgamate and modernise the existing financial services legislation under a new omnibus law governing financial institutions, payment system operators and payment instruments issuers, as well as market intermediaries licensed and supervised by the Bank, progressed further during the year. The new legislation aims to promote the continuing ability and effectiveness of the Bank in discharging its regulatory and supervisory mandate taking into consideration the more complex nature of financial services,

and commensurate approaches to regulation and supervision required to preserve financial stability and the protection of consumers. Major pieces of the proposed new legislation have been developed through an extensive process that took into account both domestic and international developments, and the cumulative body of supervisory knowledge and experience residing within the Bank. The international dimension of prudential regulatory developments however remains fluid, notably in relation to the shape and detail of new and revised core principles for effective banking and insurance supervision being contemplated by the BCBS and IAIS. Additional regulatory and supervisory requirements to deal with systemically important financial institutions have also yet to be detailed by the international standard setters. The Bank will also be seeking to engage where appropriate with the international standard setting community to take into account the likely direction of international standards. This will be pursued through the Bank's direct representation on several committees of the BCBS and IAIS, as well as through regional groupings that contribute to the reform process.

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SUPERVISORY ACTIVITIES

The Bank's supervisory activities continued to be directed at the early identification of key risks facing the individual financial institutions as well as broader system-wide issues that could give rise to risks to financial stability. The main focus of supervisory activities in 2010 was on: (i) bolstering the capacity of financial institutions to anticipate and respond to emerging risks; (ii) ensuring that identified vulnerabilities and weaknesses are followed up on and effectively rectified; and (iii) promoting responsible and

fair practices toward consumers in the light of more intense competition.

Through its supervisory activities, the Bank has observed a general strengthening of risk management practices among banking institutions. More specifically, there has been an increased focus on risk issues at the board level and boards have become more informed and participative in risk discussions, with more constructive challenge of senior management on risk issues taking place. Improvements have also been observed in the quality of risk reports to the board, with greater alignment within banks between risk appetite, business strategy and resources available (e.g. capital, skills and technology). The articulation of risk appetite statements by banking institutions have also improved with the use of a combination of quantitative and qualitative elements to express risk appetites. A further observation has been the increased use of historical data by some institutions to produce more credible risk estimates which serve to better inform key risk decisions by the board and senior management.

In the area of capital management, the Bank's supervisory reviews identified scope for further improvements in processes currently adopted by banks to ensure that capital levels remain above the minimum regulatory capital at any stage of the business cycle. While forward-looking stress tests have increasingly become an integral part of capital planning activities, the severity of the scenarios adopted by banking institutions varied considerably. In addition, most institutions were observed to only consider immediate capital needs in their capital management plans rather than the capital required over a medium-term horizon as reflected in their business plans. Some progress was however observed among the larger banking institutions to move towards the use of more sophisticated capital measurement tools that integrate their capital management with the risk measurement and analysis processes. With capital management becoming a prominent agenda at the board and senior management level, influenced by regulatory requirements under Pillar 2, the Bank expects to see even more progress among banks across the industry in the coming year towards achieving more integrated approaches to capital planning, risk measurement and business strategy. The Bank further expects that this process will support the development of more

robust approaches to the measurement of risks that are not easily quantifiable such as liquidity risk.

Improvements have also been observed in the quality of risk reports to the board, with greater alignment within banks between risk appetite, business strategy and resources available

During the second half of the year, a thematic review was conducted to examine board practices among domestic banking institutions. While improvements in the governance practices of these institutions continued to gain traction with boards displaying a good understanding of the business and providing a stronger check and balance for management, the review identified several areas in which the domestic banking institutions could further strengthen the foundations for more effective governance. These include: (i) enhancing the mix of appropriate experience and expertise on the board, particularly in the areas of risk management and financial reporting; (ii) more active participation and challenge by independent directors; (iii) reducing the burden on board members with overlapping membership in multiple board committees so as to allow for more focus on the key responsibilities of each committee; (iv) implementing a sustained programme of continuing education for board members to keep abreast with best practices and developments in the industry; and (v) putting in place more rigorous internal processes for evaluating the performance of directors and ensuring a proper succession plan for the board.

During the year, the Bank continued to conduct reviews on products under the 'launch-and-file' regime. In general, the Bank found that banking institutions had in place adequate internal processes to address financial risks to the institution from new product offerings. Further improvement was also seen in the adoption of enterprise-wide risk assessment approaches (as opposed to a silo approach) to ensure that all risks and the interplay between different risks are promptly identified, assessed and effectively

controlled. For Islamic products, the board and senior management of the Islamic banking entity have a further responsibility to ensure that the risks unique to Islamic products are also well-understood and effectively managed.

In light of more intense competition in the retail segment, the Bank heightened its surveillance of market conduct practices. More than 270 advertisements and promotional materials were reviewed by the Bank during the year, resulting in 30 incidents whereby financial institutions were directed to withdraw or modify misleading information/disclosures. The Bank also continued to monitor fees and charges imposed by financial institutions on retail consumers and small and medium enterprises to ensure that these are appropriate, reasonable and fair. Enforcement actions by the Bank resulted in a refund of RM23 million to customers of financial service providers for prohibited fees and charges imposed, and premiums charged for optional insurance products that were misrepresented as mandatory or packaged products.

The Bank's supervisory assessment framework for anti-money laundering and counter financing of terrorism (AML/CFT) was enhanced during the year to provide additional guidance for supervisors in conducting AML/CFT assessments under the RBSF and to capture new money laundering and terrorist financing trends and modus operandi due to increasing innovations in product/service offerings and advent of new technologies. The enhanced framework was applied to assess AML/CFT risks under the AML/CFT thematic reviews performed by the Bank during the year on the majority of banking and development financial institutions, and selected insurance companies.

In the area of AML/CFT compliance, substantive improvements have been observed across the industry, in line with international standards and practices and consistent with the higher expectations set by the Bank. Underpinning these improvements are a higher level of awareness and technical capability among financial institutions, developed mainly through an increased emphasis on training. Financial institutions have also graduated to more sophisticated and discerning customer acceptance and due diligence practices, leveraging on the more extensive use of IT systems and management information systems

to support the effective monitoring and management of money laundering and terrorist financing risks. More financial institutions have also moved towards a centralised transaction monitoring model as compared to decentralised monitoring by business units and branches as previously observed. Governance and oversight by management however, can be further improved to ensure the robustness of AML/CFT risk management moving forward.

Close cooperation and coordination with international supervisors continued to be pursued to support the Bank's supervisory activities. These efforts were intensified during the year to enable the Bank to identify and respond in a timely manner to emerging risks as domestic financial institutions expanded their operations abroad and vice versa. The Bank participated in two supervisory colleges and bilateral meetings held outside Malaysia and hosted two supervisory colleges as home supervisors for Malaysian financial institutions with cross-border operations. These engagements covered assessments of the economic and financial conditions in the home and host countries, sharing of respective countries' supervisory frameworks, exchange of supervisory concerns and actions, and areas for future collaboration. While experience with such supervisory colleges remains relatively new in Malaysia, the Bank is confident of evolving a more robust process for the conduct of supervisory colleges as more experience is gained. It is also expected that supervisory colleges will play an instrumental role in supporting effective mechanisms for cross-border resolutions of systemically important financial institutions going forward. Such initiatives will become increasingly important to promote domestic and regional financial stability.

The Bank's internal supervisory capacity continued to be strengthened. During the year, work commenced on the development of a micro-surveillance system with improved functionalities and data capture to support the Bank's risk analyses. The Bank also intensified its development of a strong supervisory talent pool to support the performance of the Bank's supervisory functions in the more complex environment. These include the recruitment of additional staff with relevant experience and competencies, as well as valuable experience gained by current supervisors through attachment arrangements with international financial organisations and other supervisory authorities.

