



## Prudential Regulation and Supervisory Framework

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# Prudential Regulation and Supervisory Framework

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## Introduction

Despite challenging financial and economic conditions in 2009, a sound prudential framework and continued supervisory vigilance supported the resilience of financial institutions in Malaysia. Risk-taking activities by financial institutions remained well-managed in line with the risk management capacity of institutions, limiting any impact of adverse developments in credit quality which arose from the weaker economic performance during the year. The regulatory reforms and various initiatives to consolidate the financial sector undertaken since the Asian financial crisis in 1997 has placed financial institutions on strong foundation to manage the impact of the economic slowdown. In particular, strengthened risk management capabilities enabled financial institutions to quickly identify and pre-emptively respond to emerging risks as the perimeter of the global financial crisis spread to the global economy and consequently to the domestic economy. This, has preserved the strong capital position and balance sheets of financial institutions, allowing the intermediation activities to continue undisrupted and maintaining a high level of confidence in the financial system.

While the prudential framework has stood up well to the crisis, global regulatory reforms aimed at strengthening the foundations for financial stability will have an important bearing on ongoing enhancements to current regulatory and supervisory approaches. The Bank continued to focus on delivering a prudential framework which is responsive to the changing environment, while maintaining an appropriate balance between regulatory prescriptions and supervisory judgements that are informed by the quality of an institution's governance and risk management practices. In this respect, the Bank further refined its supervisory approach to ensure that supervisory attention and resources are appropriately distributed based on well-founded assessments of the risk profiles of financial institutions. Greater attention has also been directed at further strengthening the macroprudential orientation of regulation which overlays the Bank's microprudential oversight of individual financial institutions. This has contributed towards the development of a more complete understanding

of systemic risk and its origins, and the institutionalisation of more effective inter-agency and cross-border cooperation in the areas of surveillance and supervision.

## The Bank continued to focus on delivering a prudential framework which is responsive to the changing environment, while maintaining an appropriate balance between regulatory prescriptions and supervisory judgements

In 2009, supervisory engagements with the financial industry were sustained at a heightened level to monitor and respond to developing risk issues in the industry. This included increased interactions with the board of directors and senior management of financial institutions on stress test results, risk management concerns and capital management strategies. Such interactions were particularly important to ensure that institutions were operating with adequate financial buffers as considerable uncertainty throughout the year continued to cast a shadow over the pace and extent of global recovery.

## International and domestic regulatory developments

In response to the global financial crisis, central banks and financial supervisory authorities have advanced an aggressive agenda to reform the system for global financial regulation. As part of this agenda, international standard setting bodies, including the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), are working intensively to enhance existing international standards on regulation. The body of work addresses a broad range of issues that contributed to the market failures that were observed during the crisis. Proposed reforms include measures to: (i) raise the quality and level of capital held by banking institutions; (ii) strengthen liquidity risk requirements and

management; (iii) implement forward-looking provisioning standards; (iv) align remuneration practices with risk outcomes; (v) improve transparency in the derivative markets; and (vi) strengthen supervisory frameworks and arrangements for dealing with cross-border financial groups.

### Central banks and financial supervisory authorities have advanced an aggressive agenda to reform the system for global financial regulation

There is now also broad consensus globally that the macroprudential orientation of regulation must be strengthened. This was borne out in the crisis which demonstrated how the collective behaviours of banking institutions and other highly leveraged institutions can contribute to the material build-up of risks in the financial system, ultimately undermining financial stability. Macroprudential regulation concerns itself with the stability of the financial system as a whole and responds directly to the build-up of systemic risks. In contrast, microprudential regulation concerns itself with the safety and soundness of individual entities and does not usually account for the systemic importance of institutions, the potential for collective behaviours to amplify financial and economic cycles, or the inter-connectedness of participants in the financial system.

In the wake of the crisis, the existing framework of banking regulation was acknowledged to be inadequate to address systemic risks, leading to the recent consideration of policy options at the international level aimed at substantially strengthening the macroprudential elements of financial regulation. Early proposals to this effect have been put forward by the BCBS in December 2009. These include the proposals to promote counter-cyclical capital buffers that would help ensure that the banking sector serves as a shock absorber rather than a channel through which risk is transmitted and amplified. Non-risk-based leverage limits may also be imposed to contain the build-up of leverage in the banking sector. In addition, a capital and liquidity surcharge and refinements to the capital framework are under consideration to address risks created by systemically important institutions. These proposals are currently

being evaluated by the BCBS in greater detail with more specific recommendations expected in the course of 2010.

The Bank has been an active participant in the international reform process through representations of the grouping of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) of which the Bank is a member, as well as its direct participation in the global consultation process and impact assessments. While the Bank broadly supports the proposed reforms to achieve a more risk-sensitive capital framework and more robust liquidity risk management and valuation practices, the more recent and broader package of proposals concerning the capital structure, minimum global liquidity standards, leverage and treatment of systemically important institutions will require closer scrutiny. Given the more complex nature of the issues involved, with significant repercussions for the financial system both in the short and longer term, the proposals will need to be carefully evaluated in order to fully understand the implications for financial institutions as well as financial markets in Malaysia, and ensure that the reforms do not disproportionately impair the ability of the banking sector to perform its critical role in the economy.

The Bank is currently undertaking an impact assessment to determine the cumulative impact of the proposed measures on the financial sector – including the potential impact on the financial intermediation process, institutional structures and behaviours of market participants – as input to inform the Bank's response to the proposals. Particular consideration will be given to the regulatory and supervisory framework that is already in place domestically and to what extent the current framework adequately delivers the outcomes intended by the proposed new measures. The direction for Malaysia's prudential framework will likely be between moving towards more stringent rules in some areas, while preserving flexibility under a more principle-based approach (with effective supervisory oversight) for institutions to meet clearly defined supervisory outcomes in others. In this regard, the Bank's agenda will continue to focus on promoting a competitive and efficient financial sector that supports economic growth and development, while always ensuring that this is achieved with financial stability.

With the significant exception of financial guarantee insurers, the impact of the financial crisis has been less pronounced in the global insurance industry. Notwithstanding this, the global reforms directed at the banking industry will inevitably have consequential implications for the insurance regulatory framework given the aim of avoiding regulatory arbitrage and maintaining effective oversight of systemic risk. The IAIS has already announced initiatives to converge insurer solvency frameworks internationally and develop a common framework for the supervision of internationally active insurance groups. These initiatives respond to findings of a study in 2009 by the Joint Forum (a committee comprising members of the BCBS, IAIS and International Organisation of Securities Commissions (IOSCO) to deal with cross-sectoral issues) that identified remaining key differences in the nature and scope of financial regulation among the banking, securities and insurance sectors. Specifically, the report noted that despite exposures to common risk factors and growing interactions and risk transfer across the three sectors, there are areas treated differently for purposes of prudential regulation of financial institutions under each sector's supervisory system. Differences were identified particularly in the areas of the regulation and supervision of financial groups, conceptual and technical differences in prudential regulations including capital frameworks, and the extent to which regulation deals with business conduct and consumer protection. These developments at the international level foreshadow greater convergence in the regulatory framework across the banking and insurance sectors, which in turn will have implications for the prudential framework for insurers in Malaysia.

The following sections present further details on key developments in the domestic prudential regulatory framework in 2009.

### **Capital adequacy**

In December 2009, the Bank issued the final requirements and guidance on the adoption of the Internal Ratings-Based (IRB) Approach for credit risk under the Risk-Weighted Capital Adequacy Framework (RWCAF) for banking institutions and the Capital Adequacy Framework for Islamic Banks (CAFIB). Under this approach, banking institutions are allowed to use internal estimates of risk parameters (namely the probability of default, loss given default and exposure at default) to determine regulatory

capital requirements. Banking institutions are required to obtain explicit approval from the Bank to adopt the IRB Approach. Approvals granted for banking institutions to use own risk estimates are based on supervisory assessments of a banking institution's risk management practices and risk management infrastructure to ensure that the risk estimates derived are reliable and appropriately reflect the institution's risk profile. The minimum requirements set out under the IRB Approach are largely based on guidance by the BCBS, appropriately adjusted to calibrate risk parameters more closely to the domestic operating environment and default experience.

Banking institutions or banking groups with Islamic operations are allowed to employ conventional IRB models for the Islamic banking assets if it can be demonstrated that the risk estimates derived from the conventional IRB models are reflective of the Islamic banking assets' risk profile. Islamic banking institutions leveraging on the group IRB infrastructure, processes and methodologies must further demonstrate through a clearly defined entity-level internal process that the adoption of the group common approach is appropriate for the Islamic banking institution.

The IRB framework also explicitly addresses the specificities of Islamic banking business, including an emphasis on the identification of credit risk during the different stages of financing under various Shariah contracts and adjustments of supervisory parameters to reflect the inherent loss sharing characteristics of exposures under *musharakah* and *mudharabah* contracts which bear similarities to the features of equities. The Bank expects to refine the risk parameters for Islamic banking assets over time as more data on the experience and effects of different Shariah contracts becomes available.

With the implementation of the IRB Approach, some of the larger banking institutions in Malaysia will adopt enhanced approaches to internal assessments of capital adequacy. During the year, the Bank completed supervisory reviews of 11 banking institutions, including three of Malaysia's largest banking institutions by asset size, which had been given approval in principle to adopt the IRB Approach for implementation in 2010. The supervisory review involved comprehensive assessments of the banking institutions' compliance with the quantitative and qualitative

components of the IRB minimum requirements, including the robustness of the management information systems, data quality and governance processes supporting the IRB Approach. Based on the review, approval was granted to three banking institutions to migrate fully to the IRB Approach with effect from January 2010. The remaining eight banking institutions were required to implement specific actions in relation to the application of internal models and related processes, including: (i) actions to improve the stability and reliability of newly developed and recalibrated corporate models; (ii) verify the appropriateness of downturn conditions adopted in deriving risk estimates for certain retail portfolios; (iii) improve the predictive ability of the models; and (iv) expand the use of internal ratings and loss estimates in the banking institution's day-to-day business operations. The Bank expects these issues to be fully resolved by June 2010, after which the institutions will be permitted to migrate fully to the IRB Approach in the second half of 2010. The impact on the capital levels of banking institutions migrating to the IRB Approach vary considerably among the 11 banking institutions, reflecting inherent differences in asset quality and the composition of the balance sheet.

### With the implementation of the IRB Approach, some of the larger banking institutions in Malaysia will adopt enhanced approaches to internal assessments of capital adequacy

Work on the supervisory review process (Pillar 2) of the capital adequacy framework for banking institutions was also taken forward during the year. Pillar 2 aims to promote a more rigorous process within banking institutions for assessing capital adequacy positions relative to risks, in addition to the regulatory minimum under Pillar 1. This is supported by the supervisory review process which considers the appropriateness of an institution's internal capital assessments and directs remedial actions (which may or may not entail additional capital to be maintained) where necessary. Under Pillar 2, banking institutions are expected to operate at capital levels above

the regulatory minimum implied under Pillar 1 to capture risks not explicitly included under Pillar 1 and provide adequate buffers that are commensurate with the individual risk profiles and capital management strategies of the institution. Internal capital assessments under Pillar 2 should also adequately account for conditions of stress.

Following an industry consultation process, implementation issues surrounding the quantification of Pillar 2 risks and the relationship between internal capital assessments and the supervisory review process in setting internal capital targets were raised by banking institutions. During the year, the Bank carried out additional work to assess its risk-based approach to supervision against the principles of Pillar 2. The assessment concluded that the principles of Pillar 2 have largely been captured in the Bank's Risk-Based Supervisory Framework (RBSF). In particular, assessments of capital and earnings form part of the Bank's risk assessment of individual banking institutions to arrive at an overall risk rating of the institution. In practice, institutions assessed to be of high risk may be required to hold capital levels above the regulatory minimum, together with other risk mitigation measures required to improve the institution's position. System-wide, the risk-weighted capital adequacy ratio (RWCR) currently stands at 14.7% well above the regulatory minimum of 8%, owing both to prudent capital management strategies adopted by most institutions and specific supervisory interventions in higher risk institutions.

Specific enhancements to the RBSF are being considered to further converge the Pillar 2 process with the RBSF to support supervisory judgements on the appropriateness of internal capital targets established under Pillar 2. This includes expanded considerations for capital assessments under the RBSF to take into account, in addition to the quality and adequacy of capital, the ability of a banking institution to access capital at reasonable rates and the strength of the capital management processes. The Bank will also be seeking to effectively integrate additional information which will be available under Pillar 2 on a banking institution's own internal risk assessments with the RBSF to validate the Bank's supervisory risk assessments. Final guidance on Pillar 2 will be issued in 2010 with all banking

institutions expected to fully comply with the requirements by end-2012.

Regulatory requirements on the third component (Pillar 3) of Basel II, that is disclosures supporting market discipline, were finalised during the year and issued in February 2010 for banking institutions adopting the Standardised Approach. This will be followed closely in 2010 with disclosure requirements for banking institutions adopting the IRB Approach. Pillar 3 complements the first two pillars and aims at facilitating assessments by market participants of the capital adequacy of banking institutions through disclosures of key qualitative and quantitative information on a banking institution's risk exposures, risk assessment processes and corresponding capital levels. This in turn, is intended to support the effective operation of market discipline mechanisms in regulating the risk-taking behaviours of banking institutions. As Pillar 3 disclosures are directed towards market participants, consultations on Pillar 3 included direct feedback from rating agencies which have been taken into account in finalising the Pillar 3 requirements.

For the purpose of compliance with Pillar 3 requirements, banking institutions are permitted to leverage on the Financial Reporting Standards (FRSs) disclosure requirements, thereby reducing unnecessary duplication. The disclosures under FRSs will be supplemented with additional information available to the market under Pillar 3. These include information on operational risk, capital structure, capital adequacy, the internal capital adequacy assessment process, securitisation exposures, controls around internal models, off-balance sheet exposures, back-testing and stress testing. Information on risk exposures under Pillar 3 will also be more granular and will include enhanced disclosures on securitisation exposures and off-balance sheet vehicles which are consistent with amendments by the BCBS in response to the global financial crisis. To encourage more meaningful disclosures, the Bank has elected to adopt a non-prescriptive approach for Pillar 3 which avoids mandating fully standardised disclosures. Instead, banking institutions are required to establish a formal internal policy and effective oversight processes for Pillar 3 disclosures. The Bank expects over time to evolve the quality and level of disclosures made by banking institutions under Pillar 3 as more experience is gained domestically with actual disclosure practices.

Developments in the international capital framework remain fluid with consultations still in progress on the capital proposals issued by the BCBS in December 2009 as part of its comprehensive package of reforms to strengthen the resilience of the banking sector. The proposals include: (i) a new compliance requirement at the common equity level which is defined as common shares and retained earnings; (ii) the recalibration of existing Tier-1 and total capital ratios; (iii) the need for Tier-1 capital to be predominantly in the form of common equity, which in effect will require a banking institution to reduce its reliance on hybrid securities and subordinated debt capital instruments; and (iv) capital deductions to be predominantly applied to the common equity level. While the impact of these proposals is likely to be significant for some institutions, the strong capital buffers currently maintained by the banking institutions in Malaysia will provide support for banking institutions to absorb any adjustments to the new capital requirements. The Tier-1 capital ratio and RWCR of banking institutions stood at 13.1% and 14.7% respectively, as at end-2009. Common equity and retained earnings constitute the predominant form of capital, while hybrid capital instruments contribute less than 14% of total Tier-1 capital.

The Malaysian insurance industry transitioned smoothly to the Risk-Based Capital (RBC) Framework on 1 January 2009 from the previous Margin of Solvency regime. The adoption of the RBC Framework has significantly sharpened insurers' focus on the risk drivers of the business through the risk-adjusted capital calculations and, stress and scenario testing elements embedded in the framework. This is evidenced by the more systematic consideration by insurers of key risk drivers in aligning product design, asset allocations and business strategies with an insurer's risk appetite and capital resources, thus facilitating the integration of risk and capital management activities.

### The Malaysian insurance industry transitioned smoothly to the RBC Framework on 1 January 2009

As the RBC Framework is calibrated to the average industry experience, the framework expressly requires insurers to establish own internal capital targets that are higher than the benchmark

minimum capital adequacy ratio of 130% set under the framework. For this purpose, an insurer must take into account its own specific risk profile, considering both risks that are covered in the calculation of regulatory capital under the RBC Framework and risks that are not captured, or not fully captured, in the regulatory capital calculations. As at end December 2009, the industry-wide capital adequacy ratio stood at 230%, well above the benchmark minimum. In the transition to the new framework, individual insurers were allowed some flexibility in terms of the timeframe to meet the internal capital target levels, based on capital management plans that were submitted to the Bank. Improving market conditions since the second quarter of 2009 have further stabilised the capital positions of insurers during the transition, allowing capital management strategies of insurers to proceed without material adjustments.

Earlier concerns that insurers might stay away from offering more capital intensive products following the implementation of the RBC Framework have not materialised. Notably, life insurers have continued to maintain a broad and diversified product range with more than 120 new life and medical insurance products introduced in 2009 which continued to meet the diverse needs of policyholders for protection. Pricing discipline for new products has also improved, putting insurers in a better position to meet policyholders' reasonable expectations under more volatile market conditions going forward.

Work on the RBC Framework for takaful operators (RBCT) progressed further in 2009 with the conceptual parameters of the capital model and development of the valuation components for family and general takaful business substantially completed. In the process, related considerations (e.g. concerning the use of *Qard* to rectify deficits in the Participants' Risk fund and establishment of provisions for liabilities in the takaful fund), were examined and resolved in consultation with the Shariah Advisory Council of Bank Negara Malaysia. Similar to the RBC Framework, RBCT will promote more holistic capital assessments that are aligned with the risk profiles of individual takaful operators, while specifically addressing the key inherent differences between the nature of risks assumed under conventional insurance and takaful contracts. The framework is also broadly consistent with the principles outlined in

the exposure draft issued by the Islamic Financial Services Board (IFSB) in December 2009 on Solvency Requirements for Takaful Undertakings. Consultations with the industry on the detailed RBCT and impact assessments will commence in 2010 with a target timeline for implementation of the framework on a parallel run basis by 2011.

### **Liquidity risk management**

Alongside the core workstreams on capital, the Bank initiated a review of the prudential framework for the management and supervision of liquidity risk during the year. In July 2009, the Bank issued a concept paper outlining proposed improvements to the existing Liquidity Framework which establishes minimum standards for the identification and measurement of liquidity needs by banking institutions and maintenance of adequate liquidity buffers to meet those needs on an ongoing basis. The enhancements made included expanded requirements for foreign currency liquidity risk exposures to be managed on an individual currency basis, more robust standards for the projection of cash flows, updated haircuts for liquefiable assets and, enhanced liquidity reporting requirements. In addition, greater flexibility was accorded for banking institutions with demonstrably more advanced and robust internal liquidity risk management systems to leverage on such systems for the purpose of compliance with the regulatory requirements. Industry feedback to the proposed enhancements has been received and are being analysed together with recently released proposals by the BCBS to introduce minimum global quantitative standards on liquidity. While the BCBS's proposed quantitative standards which include a 30-day liquidity coverage ratio are conceptually consistent with the Liquidity Framework adopted in Malaysia since 2000, some differences exist in the definition of liquid assets and the calibration of stress parameters for projecting cash flows. The BCBS proposals further contemplate an additional minimum long-term structural funding ratio that aims to address liquidity mismatches and incentivise banking institutions to fund activities with more stable sources of funding. Based on a preliminary assessment of the new BCBS proposals, the impact on banking institutions' liquidity positions will be significant if the proposals are wholly adopted in the current form. The Bank will perform further work in this area and is seeking additional inputs from the industry on the calibration of

the global standards, including the impact of the proposed standards on the financial markets and intermediation function. This work will also be included in the Bank's feedback to the BCBS proposals through the EMEAP grouping.

The Bank concurrently surveyed industry liquidity risk management practices to gauge the extent to which current practices were consistent with the revised Principles for Sound Liquidity Risk Management and Supervision published by the BCBS in September 2008 which reflect lessons learnt from the current financial crisis and advancements in industry practices. The survey provided valuable insights to the current state of liquidity risk management practices in the industry and highlighted potential implementation challenges in meeting the enhanced global standards enumerated in BCBS's revised principles. Responses to the survey indicated that banking institutions largely adopt prudent liquidity risk management strategies although industry practices have yet to be fully developed in some areas. The degree to which this was observed varies considerably between institutions. For some institutions, approaches to liquidity management are still predominantly driven by compliance considerations, thus limiting improvements to internal liquidity risk measurement, monitoring and control systems needed to support approaches that more fully account for developments in an institution's business and funding strategies. Banking institutions also acknowledged improvements needed to internally establish explicit and well-defined liquidity risk tolerance levels as a basis for developing more granular operational limits for liquidity risk, including limits on funding by currency and exposures to related entities.

The ability to monitor liquidity risk exposures from both an institution-wide and group-wide perspective on an ongoing basis also continued to present significant operational challenges for many banking institutions. For example, upgrades to infrastructure and processes are needed to reduce manual interventions currently required for banking institutions to extract and aggregate data across different systems for the purpose of identifying end-of-day exposures. Banking institutions also identified rigidities in data and reporting systems as an important factor currently impeding the ability to perform more incisive analysis of liquidity risk exposures.

Overcoming these limitations will be essential to support more effective liquidity risk monitoring and management practices, including the ability to perform more robust stress tests and allocate liquidity costs and risks to business activities. While this will necessarily entail significant investments by banking institutions, the transient nature of liquidity risk and its potential for triggering a loss of confidence by depositors and counterparties, particularly under conditions of stress, underscores the importance of accelerating efforts by banking institutions to further strengthen internal liquidity risk management capabilities.

From the survey and the Bank's own supervisory reviews, most banking institutions have embarked on programmes to conduct liquidity risk stress testing at regular intervals, but there remains scope for more meaningful involvement by senior management and business units in the process of identifying stress scenarios. For the most part, identified stress scenarios have been observed to be relatively mild, rarely considering more severe scenarios such as a loss of access to wholesale funding markets, lengthened horizons for stress scenarios or the closure of capital markets. While cross-functional groups (such as asset and liability management committees) are typically involved in stress testing exercises, greater scope exists for business judgement to interact with this process. The involvement of business units in the construction of stress scenarios is an example where business judgement can be applied to greater effect in the stress testing process through the consideration of a wider range of hypothetical scenarios. This will also allow for closer alignment between strategic business decisions and the liquidity risk profile of a banking institution. These issues were addressed in supervisory dialogues between the Bank and banking institutions during the year with a view to improving the rigour of liquidity stress testing practices in the industry.

### **Corporate governance**

Initiatives to enhance corporate governance practices in financial institutions continued to be a key focus of the Bank in 2009. Recognising the pivotal role of the board in promoting sound governance and risk management practices, substantial resources continued to be directed at equipping boards to effectively perform this role through a structured programme of continuing education delivered under the Financial Institutions

Directors' Education (FIDE) initiative. Since the launch of the FIDE programme in November 2008, 131 directors of banking institutions, insurers and takaful operators have completed the core programme which examines the application of good governance in the specific context of issues and challenges facing the different sectors of the financial industry. The core FIDE programme continued to be very well received, with further enhancements made to the content during the year to respond to developments in the industry, global practices and specific suggestions for improvements received from participants. FIDE's positive effect in empowering boards led to two new supplementary programmes introduced in 2009 – an introductory banking programme for directors with limited banking experience and a programme focusing specifically on risk management in Islamic finance. Work has also commenced to develop more specialised programmes for specific board roles, with immediate priority to members of the board audit committee and risk management committee. As part of the FIDE complement, eight events were organised during the year at which prominent speakers were invited to share considerable insights on a broad range of issues surrounding governance, risk and strategy which were of direct relevance to the role and expectations of boards of financial institutions.

### Since the launch of the FIDE programme in November 2008, 131 directors of banking institutions, insurers and takaful operators have completed the core programme

Beyond an educational objective, the FIDE initiative provided an important platform through which directors of financial institutions could interact with their peers and with the Bank on common issues facing boards in the performance of the oversight function. The Bank also leveraged on the opportunity to highlight its expectations of boards in ensuring the sound management of financial institutions. During the year, these engagements were particularly useful in focusing the attention of the Bank and financial institutions on developing issues

and practice in the area of governance. These included issues surrounding the board's interface with management, the process employed by financial institutions for appointing members of the board and senior management, independence criteria for board members, the interaction between risk management and internal control functions, and the relationship between parent and subsidiary boards within financial groups. The Bank will be responding to these issues in its review of the corporate governance guidelines to be issued in 2010. Further details on corporate governance practices are elaborated in the box article "Corporate Governance Developments in Financial Institutions".

Remuneration arrangements have become a focal point of global debate given the role that remuneration practices is believed to have had in encouraging excessive risk-taking by financial institutions that were most affected by the financial crisis. Executive remuneration arrangements among financial institutions in Malaysia have not raised concerns with respect to the creation of incentives for excessive risk-taking. This reflects a long-standing principle adopted in the guidelines on corporate governance and monitored for some time by the Bank that financial institutions should avoid remuneration practices that may create incentives for irresponsible behaviour. The Bank will continue to review developments in remuneration practices in the industry and consider developing additional guidances on sound remuneration practices should it be necessary, drawing on the Principles for Sound Compensation Practices issued by the Financial Stability Board in April 2009.

A more pressing issue on remuneration in Malaysia concerns the remuneration of non-executive directors. A recent survey of non-executive director remuneration levels among financial institutions suggests that remuneration levels generally do not adequately compensate non-executive directors for the significantly expanded responsibilities and time commitment assumed in what has become a far more onerous legal, regulatory and operating environment. Yet boards, and in particular non-executive directors, are instrumental to ensuring the proper stewardship of financial institutions and should be appropriately compensated for properly discharging the directors' oversight responsibilities. In support of efforts by financial institutions to attract and

### Corporate Governance Developments in Financial Institutions

The global financial crisis has focused attention on the crucial importance of effective corporate governance and risk management in preventing loss and failure in the financial system. Ineffective boards and weak senior management oversight in some of the largest global financial institutions were key contributing factors to the significant financial losses that were incurred. In many cases, institutions failed to understand and monitor the implementation of business strategies and associated risks being assumed, and to respond quickly and appropriately to deteriorating market conditions. By the same measure, institutions that performed better during the crisis were consistently differentiated by more robust governance and risk management practices in these institutions.

In the recent period, reactions to the crisis have seen international standard setters, including the Financial Stability Board and regulators in several major economies, directing attention firmly to corporate governance as a key reform agenda. The reforms have focused in particular on:

- (i) achieving an appropriate balance of skills, experience and independence in boards of financial institutions;
- (ii) strengthening board practices with increased expectations on the role, commitment and performance of the chairman and board committees;
- (iii) ensuring the effective functioning of the board on a continuing basis through a formal evaluation process and improved disclosures;
- (iv) achieving more effective approaches to induction, training and continuing development of non-executive directors to ensure that the board is kept well-informed of new developments in the financial industry;
- (v) strengthening board-level engagement in risk oversight through dedicated board risk committees that are supported by an independent chief risk officer; and
- (vi) enhancing board-level oversight of remuneration practices so as to avoid incentives for excessive risk-taking.

These developments are consistent with the direction and emphasis of changes that have shaped corporate governance practices in Malaysia's financial sector for some time now. Following the Asian financial crisis in 1997, strengthening corporate governance has been a central focus of capacity building measures aimed at providing a strong foundation for a stable and more resilient financial system. A strong corporate governance framework, supported by sound governance practices, was also identified as a key imperative for the transition from a prescriptive, rule-based regulatory regime to a more principle-based regime with greater reliance placed on the internal oversight functions within financial institutions to manage and control risks.

The resulting prudential standards on corporate governance which have been adopted for financial institutions in Malaysia are built on the following key tenets:

- (i) **clear separation of management and oversight functions** – this is enforced through the separation of the roles of chairman and chief executive officer, a strict limit on the number of executives on the board, a requirement for key board committees (namely the audit, risk, remuneration and nominating committees) to be wholly constituted of non-executive directors, and clearly delineated accountabilities between operating units and independent control functions;
- (ii) **adequately competent and committed boards** – to ensure commitment to the affairs of the financial institution, board members are expected to minimise the number of outside board directorships held that would dilute attention to the financial institution. The board must also collectively possess the requisite experience and expertise to be able to constructively challenge and guide management, particularly on risk issues and strategy. Institutions must additionally meet specific expectations regarding the orientation and ongoing training of directors;

- (iii) **presence of a strong independent element on the board** – at least a third of the board of directors of a financial institution must be independent of both management and significant shareholders;
- (iv) **a clear, explicit and dedicated focus on the oversight responsibilities of the board for risk, internal controls, remuneration, and directors and management performance and succession** – since 2005, all financial institutions have been required to establish an audit committee, a risk management committee, a remuneration committee and a nominating committee to support the effective oversight of the board in these functional areas. In the case of Islamic finance, the establishment of a Shariah Committee mandated with specific responsibility for the overall oversight of Shariah compliance is also required;
- (v) **rigorous fit and proper assessments for key functionalities** – board members, senior management and officers primarily responsible for control functions must comply with fit and proper requirements both on appointment and on a continuing basis, and financial institutions must ensure that a robust process is in place and operates effectively to ensure this;
- (vi) **incentive structures that are aligned with long-term performance and the interests of depositors and policyholders, in addition to shareholders** – boards are required to institute and monitor effective internal controls and risk management systems that address risks on an enterprise-wide basis, and avoid remuneration practices that may create incentives for irresponsible behaviour;
- (vii) **explicit responsibilities of the board for related party transactions** – boards are required to establish policies and procedures, including defined limits and appropriate approval and monitoring procedures, to ensure that risks from related party transactions are effectively managed. Boards must also ensure that policies are established to identify, prevent or appropriately manage and disclose potential conflicts of interests; and
- (viii) **sufficient reporting and disclosures on corporate governance practices** – financial institutions must describe how prudential standards are complied with, or explain any material departures and alternative measures taken to meet the intended objective of the standards. Disclosures must include information on the composition, functions and conduct of the board and its committees, an institution's risk exposures and risk management systems and an assessment of the effectiveness of the key internal control (including risk control) functions.

Observance of these prudential standards forms an integral part of the Bank's supervisory assessments of the safety and soundness of financial institutions under its Risk-Based Supervisory Framework. Assessments of the quality and robustness of an institution's oversight and control functions are both the starting point for supervisory evaluations of how an institution is managing the risks inherent within each of its significant areas of activity, and the basis on which the Bank forms an overall view of an institution's resilience, particularly under stress conditions. Recognising that financial resources are limited and often constrained during periods of stress, the emphasis on governance practices represents a critical complement to the Bank's assessments of an institution's financial performance and capital position. Emphasis is directed at how an institution's policies, processes and internal controls support prudent risk-taking that is commensurate with the level of capital and capabilities of the institution. The Bank also reviews whether these policies, processes and control mechanisms are in fact operating effectively across the institution. The outcome of these reviews is the single most important consideration in determining the intensity of supervision applied to an institution and by extension, the degree of flexibility accorded to the institution in managing its business.

Today, there is increasing evidence of practices among financial institutions in Malaysia exceeding the minimum prudential requirements and which underscore a significantly strengthened risk and governance culture. In a recent survey conducted on financial institutions in Malaysia, non-executive directors indicated an increasing commitment of time (including preparation for, and attendance at board meetings) devoted to the affairs of the financial institution, ranging up to 60 days a year. In 60% of financial institutions, more than half of current board members have direct financial sector

(including previous management) experience. This is further supported by a good mix of relevant qualifications and experience represented on the board as a whole. Independent directors form the majority on more than half of the boards of all banking institutions. More recent developments have seen a pronounced elevation of the status of the chief risk officer with strengthened authority for the management and oversight of risk at an enterprise-wide level. Several institutions have strengthened the full independence of the chief risk officer by formalising a functional reporting line directly *and only* to the board risk management committee. Improvements have also been observed in engagements between board and management on risk matters, with boards assuming greater control over the content, timing and presentation of risk information to the board. This, in turn, has supported a better appreciation of key risk developments by the board. Evidence of more engaged boards can also be observed from the retention of external expertise by some institutions to advise the board on specific issues where the board as a whole lacked the necessary knowledge and capability needed to reach informed decisions independently of management.

The introduction of the Financial Institutions Directors' Education (FIDE) programme in 2008 has played an important role in further strengthening the capacity of boards of financial institutions in Malaysia. In the 14 months since its launch, 131 directors have completed the FIDE programme. The Bank's interactions with directors who have completed the programme revealed a deeper appreciation among directors on the importance of individual contributions to the board function, a renewed confidence in engaging management on risk and strategic issues, and more effective leadership demonstrated by chairmen towards improving the functioning of the boards and board committees over which they preside. The FIDE programme has also been credited with encouraging more thoughtful approaches by boards to the selection and evaluation of board members and senior management, and a firmer hand in addressing issues of conflict and inappropriate interferences with the oversight function.

Recent global deliberations on international financial reforms have focused on the size of financial institutions with the prospect of reducing the social and economic costs of systemic failures by limiting the scale and complexity of financial institutions. In Malaysia, the financial sector is likely to expand and become more complex over time. While financial institutions in Malaysia have made significant advances in the area of corporate governance, governance practices will need to continue to evolve to take into account the changing environment. In the immediate to medium-term, pertinent developments include the greater use of and reliance on sophisticated risk management tools to identify, measure and manage risks with the implementation of the Internal Ratings-Based Approach under Basel II and the Risk-Based Capital Framework for Insurers. In addition, higher volatility and potential contagion exists as more financial institutions expand across borders and financial markets become more integrated while uncertainties remain in the pace and strength of global recovery. Other developments include the changing regulatory landscape which envisages more stringent capital requirements, more discretionary accounting practices and more explicit expectations of financial institutions to manage capital resources using through-the-cycle approaches. The development of Islamic finance will gain further momentum leading to an increasing array of new Islamic products and instruments, thus posing unique Shariah challenges. Intense competition in certain market segments have also returned the appetite for financial innovation, while competition for talent will similarly intensify.

It is the role of the board to understand how institutions are affected by these developments and consider how governance practices need to be adapted to maintain effective oversight and control. The issues for boards include:

- the design of processes and structures for effective oversight at the group level and on a cross-border basis;
- appropriate controls over the use of models and the exercise of management discretion and judgement;
- the effective integration of risk management and internal control functions and how these should interact to support the ongoing oversight of risk;
- continuing and sustained oversight of how incentive structures within the institution are responding to risk, competition and innovation;

- approaches for more effective engagements with stakeholders as part of efforts to manage expectations and preserve confidence particularly in times of stress;
- effective design of programmes for board members to be continuously kept abreast of the latest developments in the financial industry; and
- in Islamic finance, the need to account for the unique features of Shariah principles in risk management and governance.

Financial institutions in Malaysia are well placed to respond effectively to these issues, building on the institutional framework and arrangements that have been put in place over the decade following the Asian financial crisis. Enhancements to the regulatory framework on corporate governance and risk management are being pursued to respond to new developments, further promote good governance practices and reflect on lessons from the global financial crisis. The legislative framework will also be strengthened to codify the fiduciary duties and responsibilities of directors of financial institutions. With continued priority accorded to governance issues in both the supervisory and organisational frameworks, the ongoing evolution of sound governance and risk management practices will further reinforce the foundations for financial stability while enhancing the long-term competitiveness of the Malaysian financial sector.

retain high calibre non-executive directors, FIDE sponsored an independent study which will make recommendations on approaches to structure remuneration packages for non-executive directors based on best practices in comparable markets and an evaluation of the specific responsibilities, level of time commitment, and skill sets required of boards of financial institutions. The recommendations will also take into account the current and evolving financial and economic environment in which financial institutions operate and the issues that this raises for the performance of the oversight function of directors. The study is expected to be completed and released to the industry within the first half of 2010.

Measures were also taken during the year to strengthen the key role of the internal audit function as an important component of sound corporate governance. A strong internal audit function facilitates board oversight and the supervisory process by providing independent assurance that adequate internal control and risk management frameworks are in place and operating effectively within financial institutions. A concept paper on the Guidelines on Internal Audit Function was issued by the Bank in June 2009 with the aim of reinforcing a strong internal audit culture in financial institutions. The guidelines seek in particular to further emphasise the independence and professional competence of internal auditors, strengthen the risk-based focus of internal audits and provide further clarity on the relationship between the internal audit function, other control functions (such as the risk management and compliance functions), and business units where internal audit also performs an advisory role with respect to the setting up of internal controls within the business units. The final guidelines incorporating feedback received from the industry where appropriate will be issued in 2010.

### ***Risk management***

In 2009, the Bank continued to focus its resources on developing and consolidating a comprehensive set of standards on sound risk management practices, encompassing overarching principles on risk governance with more specific guidance on the management of market, credit, liquidity, operational and insurance risks. While groundwork on the overarching principles has been substantially completed, more targeted consultations with risk management practitioners in the banking and insurance industries were

carried out to test the practical operation of the principles and guidance, and capture latest developments in best risk management practices. The Financial Industry Conference on risk management organised by the Bank in November 2009 allowed for further dialogue to take place on the key risk challenges facing banking institutions and insurers. Observations of risk management responses by financial institutions to the financial and economic developments that unfolded in 2009 provided additional inputs on areas to be further developed in the principles and guidance. The Bank's work was also informed by several significant follow-up reports on observations in risk management practices among global banking institutions that were published during the year, including that published by the Senior Supervisors Group (a forum composed of senior supervisors of major financial services firms from Canada, France, Germany, Japan, Switzerland, the United Kingdom and the United States) and the International Institute of Finance.

In practice, the organisation of risk management and oversight functions among banking institutions and insurers in Malaysia has improved considerably, with significant impetus from developments in the capital and supervisory frameworks that are more sharply focused on risk, the increased scrutiny of risk functions globally following the financial crisis and directors who are more informed about risk issues and risk management approaches. The level and quality of interactions between boards and senior management on key risk issues and developments has also improved. These improvements have contributed towards strengthening the risk culture within institutions, and ensuring that risks are promptly identified, assessed and effectively controlled in line with the board's risk appetite and strategies.

More significant progress towards the adoption of enterprise-wide (as opposed to silo) approaches to risk management, with an enhanced role for the Chief Risk Officer (CRO) serving as a catalyst, is a key outcome of the Bank's risk management focus. The Bank intends, through appropriate guidance and supervisory inputs, to promote improved processes by which the CRO's position and participation in risk management and oversight processes at the highest level, covering all risks and the interplays between different risks, will be firmly entrenched. Appropriate emphasis will

also be given to accelerate required improvements to risk infrastructure in order to support the effective sharing of risk information implied by enterprise-wide risk management approaches.

### More significant progress towards the adoption of enterprise-wide (as opposed to silo) approaches to risk management, with an enhanced role for the CRO serving as a catalyst, is a key outcome of the Bank's risk management focus

In June 2009, the prudential framework for development financial institutions (DFIs) was further strengthened with the issuance of Guidelines on Best Practices for the Management of Credit Risk for DFIs. The guidelines set out the key principles and sound practices to be adopted by DFIs for credit risk management, including effective board oversight over the credit risk management infrastructure and the implementation of proper checks and balances, supported by an effective internal audit function. The guidelines acknowledge the specific mandate of DFIs to develop and promote targeted strategic sectors of the economy, with enhancements aimed to better position DFIs to perform its mandated role on a sustainable basis. During the year, flexibility was also granted for DFIs to outsource non-core functions to third party resident service providers within a sound risk management framework consistent with that adopted for banking institutions and insurers.

#### **Financial reporting standards**

Under the commitment to converge with International Financial Reporting Standards by 2012, Malaysia adopted FRS 139 Financial Instruments: Recognition and Measurement for reporting entities in Malaysia from 1 January 2010. In anticipation of the adoption of FRS 139, the Bank had already incorporated key elements of FRS 139 relating to the classification and fair valuation of financial instruments in the prudential reporting framework for both banking institutions and insurers since 2005 and 2009 respectively. The remaining components of FRS 139 that had not

been incorporated in the prudential framework were related to the use of the fair value option, and the classification and provisions for impaired loans/financing. These components which mainly affect banking institutions, were deferred to allow more time for banking institutions to make the necessary enhancements to internal systems, processes and capabilities in order to ensure the smooth implementation and integrity of financial statements reported under the FRSs. Expectations were for full alignment of the prudential reporting framework with FRS 139 by 1 January 2010. The Bank had accordingly intensified its monitoring of banking institutions' preparedness for full adoption of FRS 139 during the course of 2009 through periodic reports to the Bank and engagements with the Audit Committees, external auditors and financial reporting functions on the progress of individual institutions.

Developments took a turn in November 2009 when the International Accounting Standards Board (IASB) issued an exposure draft recommending a new approach to impairment assessments. This led the Malaysian Accounting Standards Board and the Bank to reconsider options for the full implementation of FRS 139 for banking institutions which were the most significantly impacted by the proposal. In January 2010, the Bank issued revised guidelines on Classification and Impairment Provisioning for Loans/Financing incorporating a transitional provision to be applied by banking institutions in the determination of collective impairment provisions. Under the transitional provision, banking institutions are required to provide for collective impairment provisions at a level no less than that computed based on a prescribed formula of 1.5% of total loans/financing net of individual impairment provisions. The transitional provision is intended to reduce significant duplicative costs to banking institutions associated with impending changes contemplated by the IASB, while aligning provision levels more closely to expected loss considerations. The guidelines further articulate expectations for banking institutions to implement sound internal valuation processes and methodologies for impairment assessments, with a timeline for full compliance by 2012 to coincide with the estimated timeline for adoption of the new impairment standard. Further details on IASB's new proposed impairment standard can be found in the box article "Developments in Provisioning Standards and Implications to Banking Institutions".

### **Developments in Provisioning Standards and Implications to Banking Institutions**

In November 2009, the International Accounting Standards Board (IASB) issued proposals for a fundamental review of International Accounting Standard (IAS) 39 in response to the call by the G20 leaders for both the accounting standard setters and supervisors to work urgently to implement forward-looking provisioning standards as one of the measures to address procyclicality. The proposals by the IASB are broadly in line with the high level principles issued by the Basel Committee on Banking Supervision (BCBS) in August 2009. These proposals reflect lessons learned from the financial crisis, particularly the need for earlier recognition of loan losses based on sound methodologies that capture expected credit losses, including changes in loss expectations as conditions affecting borrowers change.

This article explains the new proposals on impairment by the IASB and discusses its implications for banking institutions in Malaysia.

#### **Problems with incurred loss impairment approach**

Under the present incurred loss model applied in IAS 39, loans may be classified as impaired *only* when there is objective evidence that a loan or portfolio of loans will not be repaid in full. Such evidence (known as a trigger event) may be specific to an individual loan (e.g. bankruptcy) or an occurrence of an event that is likely to lead to defaults across a portfolio of loans (e.g. increase in unemployment and a downturn in the property market that may lead to an increase in mortgage defaults).

Expected future credit losses are not recognised until a trigger event has occurred. This approach received criticism during the global financial crisis for failing to account for loss expectations even though such losses are factored in (based on historical experience or judgments made by lenders about likely default experience) when loans are made and priced by banking institutions. As a result, the recognition of expected losses is delayed, while interest revenue is generally overstated before the trigger event occurs. The subsequent recognition of credit losses, in turn, causes abrupt adjustments to income levels of banking institutions when a trigger event occurs, thereby reinforcing the procyclical impact of a financial crisis or general economic downturn. Inconsistencies among banking institutions in defining and assessing trigger events have further reduced the comparability of impairment provisions for similar financial assets across institutions.

#### **Proposals for expected loss impairment approach**

The new proposals by the IASB which adopts the impairment method based on expected losses will require entities to:

- (i) determine the expected credit losses on a financial asset when that asset is first obtained;
- (ii) recognise contractual interest revenue, less the initial expected credit losses, over the life of the financial asset;
- (iii) build up a provision over the life of the financial asset for the expected credit losses;
- (iv) reassess the expected credit loss at each period; and
- (v) recognise immediately the effects of any changes in credit loss expectations.

The proposals also include expanded disclosure requirements that compare the development of credit loss provisions and cumulative write-offs by year of origination for each class of financial assets. This will allow users of financial statements to track the development of losses over time and form an opinion on the accuracy of management's estimates.

A comparison<sup>1</sup> of the current incurred loss approach and the proposed expected loss approach is summarised below.

Incurring loss approach	Expected loss approach
<ul style="list-style-type: none"> <li>Interest revenue for financial assets is recognised on the basis of expected cash flows excluding expected credit losses.</li> </ul>	<ul style="list-style-type: none"> <li>Interest revenue for financial assets is recognised on the basis of expected cash flows including expected credit losses.</li> </ul>
<ul style="list-style-type: none"> <li>Impairment is recognised only when a loss event occurs (known as an impairment trigger).</li> </ul>	<ul style="list-style-type: none"> <li>Expected credit losses are continuously re-estimated without reference to loss events or impairment triggers.</li> </ul>
<ul style="list-style-type: none"> <li>Losses that are expected to arise from future events are not recognised.</li> </ul>	<ul style="list-style-type: none"> <li>Impairment is recognised from an adverse change in credit loss expectations and can be reversed by subsequent favourable changes.</li> </ul>
<ul style="list-style-type: none"> <li>Interest revenue can be viewed as 'overstated' in periods before a loss event occurs.</li> </ul>	<ul style="list-style-type: none"> <li>Interest revenue reflects the total net return expected at inception.</li> </ul>

The proposed expected loss impairment standard is expected to be finalised by the IASB in the second half of 2010 with an effective date for mandatory adoption not earlier than three years from the finalisation of the standard.

### Implications for banking institutions in Malaysia

The move towards more forward-looking provisioning under the expected loss approach aims to better align loan loss reserves with risk management and supervisory approaches which are concerned with loss developments associated with plausible *future* events, as opposed to losses based on *known* events which underpin the current incurred loss model. The gradual build-up of reserves over time will also result in higher reserves held by banking institutions when entering periods of deteriorating credit quality. This in turn will reduce the pressure on bank earnings and capital as loan losses materialise, thus supporting the intermediation activities during periods of stress or economic downturn.

Provisioning based on the expected cash flow model as proposed by the IASB, however, presents several operational challenges for banking institutions. To determine expected losses, a banking institution must forecast expected credit losses and the timing of such losses over the life of financial assets (either on an individual or on a portfolio basis). Depending on the size and complexity of the institution's loan portfolio, this may be an operationally complex undertaking, requiring systems changes to be made and significant lead-time to implement. The incremental effort to implement the new provisioning standards will generally be more significant for banking institutions that are adopting the Standardised Approach for credit risk under Basel II. Such banking institutions will need to develop anew, or substantially recalibrate systems modelled on the incurred loss approach to compute estimates of future cash flows and credit losses.

In contrast, banking institutions, including six domestic banking institutions, that are adopting the Internal Ratings-Based (IRB) Approach for credit risk under Basel II are already required to take into account expected loss considerations in estimating probabilities of default for the purpose of determining regulatory capital. For these banking institutions, the same data collected for capital purposes would also support the estimation of expected loss for provisioning purposes. Common factors should also drive internal credit risk ratings for both capital and provisioning purposes. These

<sup>1</sup> Source: [www.ey.com/IFRS](http://www.ey.com/IFRS)

similarities enhance the prospects for IRB banks to leverage on existing infrastructure supporting regulatory capital requirements to meet the proposed provisioning standards. However, some key differences remain, including different assumed time horizons, point-in-time versus through-the-cycle conditions applied for capturing losses and different rates used for discounting cash flows. These differences will require material adjustments to be made to the calibration of IRB models for provisioning purposes.

Under an expected loss approach, changes in expectations of credit losses will have an immediate and direct impact on earnings, potentially resulting in a higher degree of earnings volatility from year to year. The extent of volatility will depend particularly on the time horizon over which estimations are made, economic developments and the effects of changes in portfolio compositions and underwriting practices over time. While longer time horizons will result in more stable parameters, data limitations would be a key constraint. Under these circumstances, it will become more important for banking institutions to integrate the outputs generated from applying an expected loss approach with considerations of business, capital and risk management strategies as well as current measures of performance. This is also important with the more extensive qualitative and quantitative disclosures required under the expected loss approach which will contribute towards greater market discipline as more information is made available about the quality of a banking institution's loan book.

Practical solutions are being pursued at a global level to address these challenges. Specifically, the BCBS has been tasked to develop proposals that would allow banking institutions to draw on their risk management and capital adequacy systems to determine provisions based on expected losses for accounting purposes. Additional proposals are also expected to respond to the interest of ensuring that the provisioning approach is subject to appropriately rigorous and independent internal and external validations.

Additional implementation costs in Malaysia also arise from an earlier announcement made in 2008 by the Malaysian Accounting Standards Board to adopt Financial Reporting Standard (FRS) 139 (Malaysian equivalent of the current IAS 39) for all reporting entities in Malaysia with effect from 1 January 2010 in line with the policy of convergence with international financial reporting standards. The interim implementation of an incurred loss model and subsequent change within a relatively short period to an expected loss model would potentially add further costs to banking operations. Given this and the present fluid nature of international developments that will have important implications on the shape of the expected loss impairment standard, transitional arrangements have been allowed for banking institutions in Malaysia with respect to the implementation of FRS 139. This aims to reduce duplicative system costs and resources associated with implementation of FRS 139, while facilitating the direct migration of systems and processes to support the expected loss approach.

The transitional arrangement, which allows banks to maintain current approaches for establishing general provisions, is accorded to banking institutions for the assessment of collective impairment provisions under FRS 139. Loans that are individually assessed for impairment must comply fully with FRS 139, consistent with the move to incorporate a broader range of credit information, both quantitative and qualitative, in provisioning methodologies for individually significant loans (previously, provisions for such individual loans were established based only on months-in-arrears). Further details on the provisioning standards applicable to banking institutions are discussed in Chapter 3 under 'Financial Reporting Standards'.

Outside the impairment standard, revised Guidelines on Financial Reporting were issued by the Bank in February 2010 to bring other aspects of financial reporting requirements under the prudential framework for banking institutions further in line with FRSs requirements (including the remaining components of FRS 139 which have not yet been adopted by the Bank). The guidelines retain restrictions on the application of certain options available under FRSs where considered necessary for prudential purposes, and requires additional disclosures to be made with respect to information on loans, impairment provisions and remuneration. Further guidance is also provided on expected controls over the application of the fair value option under FRS 139.

### ***Islamic finance and takaful operators***

In the area of Islamic finance, regulatory efforts in 2009 continued to be directed at strengthening Shariah governance, promoting sound business practices and enhancing operational efficiencies in Islamic financial institutions. During the year, proposed revisions to the Rate of Return (ROR) Framework for Islamic banking institutions were completed with the aim of augmenting the operational efficiency of Islamic banking institutions through the improved management of profit-sharing investment accounts (PSIAs). The underlying objectives of the proposed changes are to ensure that depositors receive a fair and equitable portion of the investment profits, reduce information asymmetries between the Islamic banking institutions and depositors through better disclosures, and provide for the enlarged and more diversified scope of Islamic banking business. The proposed revised ROR Framework has also taken into account relevant standards related to PSIA that have been issued by the IFSB. The concept paper on the revised Framework will be issued in the first half of 2010 as a basis for further consultations with the industry.

In April 2009, the Bank issued the Guidelines on Investment Management which is applicable to takaful and retakaful operators. The guidelines set out the minimum expectations on the effective governance and management of investment activities of takaful funds, which are in line with international standards prescribed by the IFSB and the IAIS. This was followed in December 2009 with the issuance of a concept paper on Guidelines on Takaful Operational Framework (TOF), which establishes principles governing the operational

processes of takaful business to ensure that business activities and innovations are within the takaful operators' risk management capacity and do not compromise the long-term sustainability of the business. It also aims to strengthen safeguards to protect the interests of takaful participants. In addition, the TOF provides guidance on the operational processes involving takaful and shareholders' funds, including requirements on fund establishment, management of fees and operating costs of the takaful operators. It also covers the management of assets, liabilities and surplus, mechanisms to address any deficiency in the takaful funds, and broad requirements on disclosure and transparency.

In line with efforts to further enhance the Shariah governance of Islamic financial institutions, a new Shariah Governance Framework will be issued in 2010 to provide comprehensive guidance on the roles and responsibilities of the Shariah committee, and the board and management of Islamic financial institutions in ensuring that the operations of the Islamic financial institutions are in compliance with Shariah principles. This is further elaborated in the box article "The New Shariah Governance Framework".

**A Shariah Governance Framework will be issued in 2010 to provide comprehensive guidance on the roles and responsibilities of the Shariah committee, and the board and management of Islamic financial institutions in ensuring that the operations of the Islamic financial institutions are in compliance with Shariah principles**

### ***Legislative reforms***

In November 2009, the Bank announced a broad undertaking to carry out a comprehensive review of all the existing legislation governing financial institutions and payment systems under the Bank's purview to take account of the changing financial landscape and regulatory developments that have

### The New Shariah Governance Framework

#### The importance of Shariah governance

The principles of Islamic finance place great emphasis on strong corporate governance values and structure, transparency, disclosure of information and strict adherence to Shariah principles. The Shariah governance framework is a set of organisational arrangements through which Islamic financial institutions ensure effective oversight, responsibility and accountability of the board of directors, management and Shariah committee. The framework serves as a guide towards ensuring an operating environment that is compliant with Shariah principles at all times. Shariah principles provide the foundation for the practise of Islamic finance through the observance of the tenets, conditions and principles propagated by Islam. Comprehensive compliance with Shariah principles would bring confidence to the general public and the financial markets on the credibility of Islamic finance operations.

In Malaysia, the Bank has established the necessary mechanism for the Islamic financial system to operate in a manner consistent with Shariah *muamalah* principles, with a clearly defined institutional arrangement within Islamic financial institutions regulated by the Bank. A two-tiered Shariah governance structure has been established, comprising an apex Shariah advisory body at the Bank and a supervisory Shariah committee formed at the respective Islamic financial institutions.

#### Central Shariah advisory council

The Shariah Advisory Council of Bank Negara Malaysia (SAC) was established in 1997 as the ultimate authority to decide on all Shariah matters pertaining to the Islamic banking and takaful industry. It serves as the final arbiter in the interpretation of Shariah principles on Islamic banking and takaful matters and practices, and promotes the harmonisation of Shariah interpretations among the Shariah committees residing in the individual Islamic financial institutions. The mandates of the SAC as provided under section 52 of the Central Bank of Malaysia Act 2009 (the Act) are as follows:

- ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it;
- advise the Bank on any Shariah issues relating to Islamic financial business, the activities or transactions of the Bank; and
- provide advice to any Islamic financial institution or any other person as may be provided under any written law.

To reflect the critical role of the SAC, its members are appointed by the Yang di-Pertuan Agong from amongst persons who are qualified in Shariah, or who have knowledge or experience in Shariah, banking, finance, law or other related disciplines.

An important development under the Act is the requirement for the court and arbitrator to take into account the published rulings of the SAC and to refer any Shariah issues to the SAC for its ruling. All SAC rulings in such cases are binding on the Islamic financial institutions, courts and arbitrators. This represents an important step forward as previously the rulings bind the arbitrator, but not the courts. This further enhances the consistency in application of Shariah rulings, thus securing certainty and finality on Shariah issues relating to Islamic finance applications and practices.

#### Establishment of individual Shariah committee at Islamic financial institutions

The Islamic Banking Act 1983 and Takaful Act 1984 require the establishment of an independent Shariah committee within each Islamic financial institution. In 2004, the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (the Guidelines) was issued outlining the role, duties and responsibilities of Shariah committee and its members and the relationship and working arrangement between the Shariah committee at individual institutions and the SAC at the national level. The Guidelines, among others, prohibit individuals from sitting in more than one committee within the same industry. While the underlying rationale for the prohibition is to avoid a conflict of interest, the rule served as a catalyst in expanding the pool of Shariah talent within the Islamic financial industry and, at

the same time, increasing its diversity in terms of the experience and expertise of Shariah experts. Today, the total number of Shariah experts has increased to more than 100 individuals from a small number of scholars when the Guidelines was first issued in December 2004.

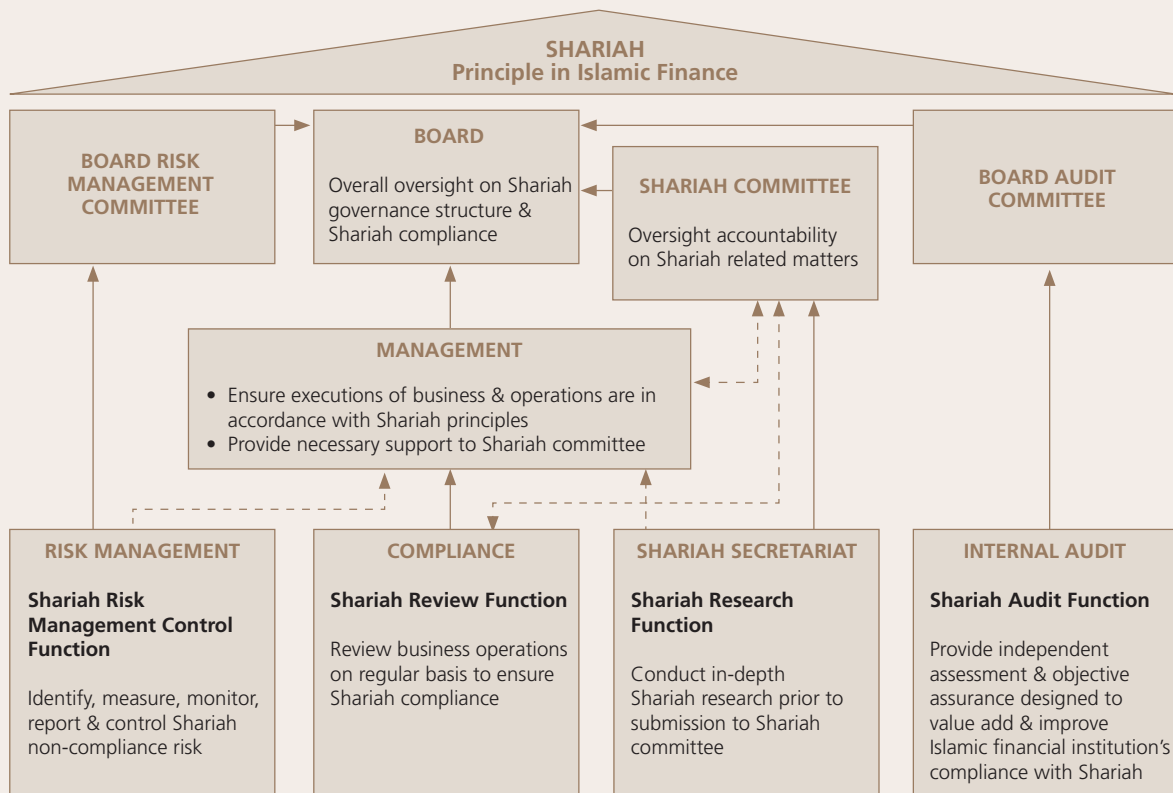
Although the current Shariah governance structure has increased the prominence of the role of the Shariah committee within the Islamic financial industry, the further enhancements to the Guidelines are needed to take into account the rapid developments in Islamic finance in this recent few years. These include, the enhancements relating to the governance arrangements of the board and management in respect to the Shariah compliance process, the independence and accountability of the Shariah committee in the decision making process, the strengthening of internal research capacity, compliance and the risk management processes.

**A new Shariah framework**

To further strengthen the Shariah governance structure, the Bank will be issuing a new Shariah governance framework for the Islamic financial institutions under the Bank’s purview with the following objectives:

- to set out the expectations on an Islamic financial institution’s Shariah governance structures, processes and arrangements with the goal of ensuring that all operations and business activities are consistent with Shariah principles at all times;
- to provide comprehensive guidance to the board, Shariah committee and management of Islamic financial institutions in discharging its duties on matters relating to Shariah; and
- to ensure proper functioning of Shariah compliance through effective Shariah review and Shariah audit functions.

**Chart 1  
Shariah Governance Framework Model for Islamic Financial Institutions**



In developing the framework, the Bank has taken into account the Islamic Financial Services Board's (IFSB) Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services issued in December 2009 and also relevant practices observed in jurisdictions that have a substantial Islamic banking and finance sector.

The framework aims essentially to strengthen the Shariah governance process, decision making, accountability and independence. To reinforce the Shariah compliance functions, internal Shariah review and audit requirements will be introduced, supported by an appropriate risk management process and research capability. It is envisaged that the implementation of the framework will contribute towards evolving a more robust and sound Shariah governance framework within Islamic financial institutions which, in turn, will promote Shariah compliance throughout the organisation.

Under the framework, the board will be responsible for the overall Shariah oversight of Islamic financial institutions and the effective functioning of the Shariah governance structure, policies and processes. However, the board must recognise the independence of the Shariah committee and uphold the committee's decisions on Shariah aspects of the institution's business operations. While the framework does not specifically require an Islamic financial institution to appoint a Shariah expert among its board members, the board is encouraged to consider co-opting members on the board who have strong Shariah knowledge in order to serve as a 'bridge' between the board and the Shariah committee. The board shall also reasonably remunerate the Shariah committee members, to commensurate and reflect the accountability, duties and responsibilities of the Shariah committee.

The role and function of the Shariah committee has been expanded further from merely advisory in nature to assume a higher degree of accountability. The Shariah committee will now be accountable for the implementation of decisions and opinions throughout the Islamic financial institution. Consistent with its stature, the Shariah committee shall have direct access to the board. The Shariah committee shall also report directly to the Bank where the committee believes that non-compliances on Shariah matters in the Islamic financial institution have not been effectively and adequately addressed by the Islamic financial institution.

In supporting the board and the Shariah committee, the senior management of an Islamic financial institution is responsible to promote a strong culture of Shariah awareness and compliance within the organisation, including implementing best practices in Shariah governance in all aspects of the institution's operations. The senior management is also responsible for ensuring that all submissions to the Shariah committee are adequately researched and supported by a thorough study on the Shariah issues, product structuring and documentation. This would entail the development of internal Shariah research capabilities which are supported by adequate knowledge and resources to provide and undertake research effectively.

Islamic financial institutions are also expected to establish three functions that provide a system of checks and balances within the organisation, which include the following:

- a Shariah risk management control function that is able to identify all possible risk of Shariah non-compliance and, where appropriate, remedial measures to manage this risk;
- a Shariah review function that continuously assesses Shariah compliance of all activities and operations. Where instances of non-compliances are identified, the institution is expected to take prompt rectification measures and put in place the necessary mechanisms to avoid such recurrences; and
- a Shariah audit function that performs annual audits to provide an independent assessment of the adequacy and compliance of the Islamic financial institution with established policies and procedures, and the adequacy of the Shariah governance process.

### **Conclusion**

With the rapid expansion of Islamic finance in Malaysia, the establishment of a comprehensive and holistic governance structures and processes is being continually enhanced to remain dynamic and relevant at all times. The Shariah governance framework in Malaysia has evolved with the changing market conditions, whereby the governance structure at both the overall Islamic financial system and the individual Islamic financial institutions have been enhanced and strengthened to ensure the observance of Shariah. The effective implementation of the new Shariah governance framework will further promote stakeholders' confidence and the integrity of the Islamic financial industry thereby reducing Shariah non-compliance risks and, over the medium term, contribute towards maintaining financial stability.

occurred over the last two decades. The affected pieces of legislation are the Payment Systems Act 2003, Insurance Act 1996, Banking and Financial Institutions Act 1989, Takaful Act 1984 and Islamic Banking Act 1983. The purpose of the review will be to: (i) ensure an effective and efficient legislative framework for the regulation and supervision of financial institutions and oversight of payment systems; (ii) align legislation with more principle-based and differentiated approaches to regulation and supervision based on risk; (iii) enhance the Bank's ability to take appropriate enforcement, remedial, intervention and resolution actions to promote institutional stability; (iv) achieve a more consistent legal framework across the different financial sectors in common areas; and (v) strengthen provisions to support more effective market conduct regulation and supervision. Detailed proposals on the legislative changes are expected to be finalised by the end of 2010.

The proposed legislative changes will further reinforce the strengthened financial stability framework in Malaysia following the enactment of the new Central Bank of Malaysia Act 2009 (CBA) that came into force on 25 November 2009. The new CBA clarifies the Bank's mandate for financial stability and provides expanded powers for the Bank to undertake surveillance and the prompt resolution of financial institutions, including non-regulated institutions that are systemically important. A further elaboration on the provisions under the CBA is provided in the box article "Safeguarding Financial Stability under the Central Bank of Malaysia Act 2009".

### Legislative changes will further reinforce the strengthened financial stability framework in Malaysia following the enactment of the new Central Bank of Malaysia Act 2009

#### Supervisory activities

The Bank's supervisory focus in 2009 continued to be directed towards ensuring the resilience of financial institutions to the risks arising from the global financial crisis and the economic slowdown that followed. System-wide vulnerabilities that originated from the inter-connectedness of

the global financial system prompted closer examinations by the Bank of the inter-linkages between the domestic and overseas operations of financial institutions. More frequent engagements were pursued with management and boards of financial institutions to discuss the potential pressure points and risk drivers affecting individual institutions as highlighted from stress tests carried out by the financial institutions and the Bank. With more extensive cross-border operations of the major domestic financial conglomerates, the need for greater collaboration between the Bank and host regulators within the region was also prioritised to support the effective supervision of financial groups. To this end, the Bank is finalising the home-host supervisory framework to facilitate the timely sharing of information and improved cross-border collaboration between the Bank and other home and host supervisors.

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Liquidity risk management continued to be a central focus of supervisory visits throughout the year. The Bank conducted more rigorous liquidity stress tests in 2009 incorporating both funding and market liquidity risk factors. The results of the stress tests were used as a base for discussions with the management and boards of financial institutions on the robustness of the institutions' liquidity risk management practices and contingency funding plans. Financial institutions with cross-border operations were observed to have strengthened processes for the global management of liquidity, backed by improved infrastructure for global treasury operations and enhanced management information systems. The valuation of financial instruments and market liquidity also came under close scrutiny as foreign currency liquidity evaporated, triggered by

heightened credit concerns and risk aversion. Given these continued constraints, supervisory attention was focused on ensuring that financial institutions incorporated the most current assumptions in the liquidity behavioural analysis, and testing contingency funding plans to ensure that these plans were operationally robust. Going forward, greater scope exists for liquidity stress testing to be integrated with other organisational stress testing initiatives, such as those impacting capital, earnings and asset quality.

Efforts to strengthen the Bank's supervisory practices and infrastructure remained an important priority for the Bank to ensure its continued effectiveness in discharging its mandate for financial stability. The Bank continued to expand its capabilities to support the timely identification and resolution of vulnerabilities facing licensed financial institutions. During the year, the Bank embarked on a project to develop a microsurveillance system to facilitate

the continuous surveillance of financial institutions through the use of business intelligence tools and a centralised repository system. The system also supports the prompt identification of emerging risks and vulnerabilities in financial institutions which could have an impact on the stability of the financial system. Approaches to the supervision of financial conglomerates and the implementation of the risk-based supervisory approach were also further enhanced. In 2009, a Supervisory Practice Unit was established to support the consistent application of the risk-based supervisory approach across the different financial institutions and sectors supervised by the Bank. The unit is responsible for conducting research, reviewing and updating supervisory practices and methodologies, and ensuring the consistent interpretation and implementation of the risk-based supervisory framework by supervisors through the establishment of appropriate processes and systems to support sound supervisory assessments.