



Prudential Regulation and Supervisory Framework

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(Diminishing Partnership)*

Prudential Regulation and Supervisory Framework

Maintaining a robust, effective and efficient regulatory and supervisory framework remained a key priority for Bank Negara Malaysia in 2007. Given the continuing evolution of the financial landscape as well as the greater volatility in the financial markets, the Bank remained focused on ensuring that its prudential regulations and supervisory framework are responsive to changing economic conditions in maintaining the resilience of financial institutions, while providing a conducive environment for financial innovation and growth.

The Bank is responsible for the regulation and supervision of commercial banks, investment banks, Islamic banks, insurance and reinsurance companies as well as takaful and retakaful operators. Since 2002, the Bank also assumed responsibility for the regulation and supervision of six development financial institutions which are charged with specific mandates within the broader financial sector. The Bank also regulates insurance brokers, loss adjusters, money brokers and payment system operators which are covered in the chapters "Market Conduct and Enhancing Financial Capability" and "Payment and Settlement Systems".

The evolution of the regulatory and supervisory framework in the recent period has been cognisant of the fundamental changes to the financial landscape, characterised by the following trends:

- the increasing diversity of the financial sector which has seen the emergence and more significant presence of new players in the market such as investment banks, private equity firms, boutique investment advisors as well as new international players in Islamic finance;
- increasing linkages between the banking, insurance and capital market sub-sectors as a result of financial conglomeration and with it, greater financial innovation at a much faster pace than previously experienced;
- the significant growth of Islamic banking which now accounts for 15.4% of the assets of the banking system, which has further contributed to the increasing level of product sophistication and innovation;

- the growing importance of market-based finance, with the capital markets assuming a more significant role in the financing of economic activities. This in turn, has resulted in banking institutions shifting more towards treasury-based activities while stimulating the growth of the derivatives market; and
- the growing volume of cross-border capital flows with greater global financial integration both in terms of the increased foreign participation in the Malaysian financial sector and the increased regional expansion by domestic players.

In adapting to these new trends, the Bank's approach to regulation and supervision has focused on three main complementary strands:

- firstly, achieving an optimal balance between principle-based and rule-based regulation to appropriately reflect the greater complexity and diversity of the financial sector, while having the agility to continuously adapt to changing economic and market conditions;
- secondly, the implementation of an enhanced risk-based supervisory framework with more granular assessments of individual institutions' unique risk profiles and risk management control functions, thus ensuring that supervisory attention continues to be proportionately focused on financial institutions that are of higher risk; and
- thirdly, strengthening the conditions for effective market discipline to play a more important role in ensuring sound financial and business practices by financial institutions.

Progress achieved on each of these strands has also resulted in the closer alignment of the Bank's regulatory and supervisory framework with international standards and guidance issued by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the Islamic Financial Services Board.

IMPLEMENTATION OF PRINCIPLE-BASED REGULATION

Principle-based regulations have gained greater prominence within the prudential framework. Under a more principle-based regulatory regime, prudential standards issued by the Bank have

progressively shifted towards establishing high level principles, in place of detailed prescriptions, which frame the Bank's supervisory expectations regarding sound financial and business practices. This shift is not synonymous with less supervision or regulation, but aims to achieve greater focus on an institution's ability to effectively manage its risks instead of a mechanical compliance with detailed rules. This, in turn, would result in a regulatory framework that is more robust against the vagaries of changing market conditions, while addressing the limitations of a "one-size-fits-all" rule-based regulatory system through an appropriate differentiation between institutions according to their size, complexity and risk profile. Financial institutions have considerable flexibility within this framework to determine the most appropriate means by which the Bank's supervisory expectations can be met in a way that is also in line with the institution's own strategic objectives and business models. The Bank believes that ultimately, this approach is more sustainable over time in reinforcing financial stability and promoting a more competitive financial system.

The implementation of a more principle-based regulatory regime for the financial sector in Malaysia remains at a relatively early stage. While committed to this process, significant attention continues to be directed at strengthening the preconditions necessary to support the move towards a more principle-based regulatory framework without compromising financial stability outcomes. This is reflected in the clear emphasis placed on corporate governance over the recent few years, beginning with substantive revisions to the Bank's prudential standards on corporate governance. The new standards focus in particular on the role of the board and senior management in ensuring a sound risk management and internal control environment within financial institutions. These standards set out the Bank's expectations regarding effective board compositions that include strong independent members, the presence of relevant competencies on the board and senior management team, transparent board processes and clearly delineated accountabilities for operating and internal oversight functions.

The Bank's supervisory processes have also concurrently been enhanced to ensure that directors and chief executive officers of financial institutions fulfil fit and proper criteria on an

ongoing basis. In addition to supervisory reviews carried out to check the suitability of proposed chief executives and directors prior to their appointments, the Bank also engages more frequently with the board and senior management of financial institutions, either individually or collectively, on key strategic and risk developments affecting the institution. This has facilitated more effective assessments of how the board and senior management are discharging their responsibilities in practice, while providing deeper insights into potential governance issues within an institution.

Based on the Bank's ongoing supervisory assessments, the effectiveness of board oversight and senior management has, on the whole, continued to improve. More specifically, a heightened awareness of risk with clear strategies for managing key risks, enhanced disclosures, closer scrutiny of management by the board and prompt actions to detect and remedy internal control deficiencies have been evident among financial institutions. Financial institutions which did not meet the Bank's supervisory expectations were required to maintain a higher proportion of independent directors, or replace board members or chief executives who no longer fulfilled the fit and proper criteria. These developments underpinned the presence of stronger governance structures within institutions and supported the growing momentum towards principle-based regulations in more recent periods.

The shift towards more principle-based regulations is not absolute, but rather aims to strike an optimal balance between principle-based and rule-based regulations.

Since 2001, more than 50 prudential standards have been developed or reviewed under a more principle-based regulatory approach. In the process, a majority of prescriptive limits and regulatory requirements or restrictions have been replaced with broad principles that emphasise the responsibility of the board and senior management to manage risks in a manner appropriate to the circumstances and exposures of a particular institution. Among the regulatory prescriptions that have been abolished under the more flexible, principle-based regulatory regime

are the individual counter limits imposed on investments in shares by banking institutions, restrictions placed on credit facilities to connected parties, prescribed scenarios for stress testing and prior notification requirements for the introduction of new products.

The shift towards more principle-based regulations is not absolute, but rather aims to strike an optimal balance between principle-based and rule-based regulations in order to preserve a sound prudential framework at the different stages of development of the financial sector. Prescriptive rules and requirements are accordingly retained in specific areas. For example, baseline, or Pillar 1, capital adequacy requirements for the

banking and insurance sectors which are a fundamental cornerstone of the prudential framework remain largely prescriptive in nature. The Bank considers certainty and consistency in this particular area essential to maintain confidence in the financial system and avoid materially distortive competitive effects in the system. Regulatory reporting requirements have also remained prescriptive to facilitate the Bank's micro- and macro-surveillance functions. Where appropriate, the Bank has retained prudential limits as well – for example, on exposures to single counterparties – in certain areas as a minimum safeguard against excessive risk-taking. More specific prudential requirements have also continued to serve a useful purpose in achieving

Prudential Standards Issued in 2007

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|---|---|
| <p>(i) Guidelines on Investment in Shares and Interest-in-Shares (issued in February 2007)</p> | <ul style="list-style-type: none"> ■ Provides greater flexibility for banking institutions to undertake equity-related activities according to the institution's internal risk management policies. |
| <p>(ii) Guidelines on Stress Testing (issued in March 2007)</p> | <ul style="list-style-type: none"> ■ Introduces a more robust stress test regime by giving financial institutions greater flexibility in designing their stress test framework that would be most appropriate for their business profile, while encouraging financial institutions to better understand the risk drivers of their institution. |
| <p>(iii) Guidelines on the Role of the Appointed Actuary for Takaful Operators (issued in March 2007)</p> | <ul style="list-style-type: none"> ■ Sets out the expected quality of actuarial investigations into the financial condition of family takaful funds by, among others, setting out: <ul style="list-style-type: none"> • the qualifying criteria for the appointment of appointed actuaries; and • their responsibilities to continuously evaluate the financial well being of the family takaful business, having due regard to certificate holders' reasonable expectations and developments in the business that may impact the financial condition of the funds. |
| <p>(iv) Property Development and Property Investment Activities by Islamic Banks (issued in March 2007)</p> | <ul style="list-style-type: none"> ■ Sets out the duty of the boards of Islamic banks to ensure that adequate governance, sound internal controls and a strong risk management infrastructure are in place to support Islamic banks' direct participation in property development and property investment activities which is allowed under the Islamic Banking Act 1983. |
| <p>(v) Revised Risk-Weighted Capital Adequacy Framework (issued in April 2007, implementation from January 2008)</p> | <ul style="list-style-type: none"> ■ Sets out the methodologies for quantifying the minimum regulatory capital requirements for credit, market and operational risk for conventional banking institutions. |

<p>(vi) Risk-Based Capital Framework for Insurers (issued in April 2007, implementation from January 2009)</p>	<ul style="list-style-type: none"> ■ In October 2007, the market risk component was incorporated in the framework with enhanced guidance on trading book governance and the provision for banking institutions to adopt the Internal Models Approach, subject to the Bank's approval. ■ Replaces the existing solvency framework with the parallel run commencing from June 2007. ■ Sets out more transparent and risk-adjusted capital and valuation requirements that address all major financial risks of insurers. ■ A similar framework for takaful operators is being developed, with a concept paper expected to be released in 2008.
<p>(vii) Valuation of Liabilities for Mortgage Reducing Term Takaful (MRTT) (issued in April 2007)</p>	<ul style="list-style-type: none"> ■ Specifies the minimum valuation requirement based on the net premium valuation method to be adopted by takaful operators in determining the reserves that must be provided for to meet future liabilities under MRTT contracts.
<p>(viii) Capital Adequacy Framework for Islamic Banks (issued in June 2007, implementation from January 2008)</p>	<ul style="list-style-type: none"> ■ Sets out the capital adequacy requirements for Islamic banks covering credit, market and operational risks, which are consistent with the Capital Adequacy Standards issued by the Islamic Financial Services Board. The framework addresses risk characteristics unique to Islamic finance contracts. ■ Introduces specific capital requirements for inventory and commodities risks to reflect exposures to price fluctuations associated with the ability of Islamic banks to undertake the sale and purchase of assets.
<p>(ix) Guidelines on Credit Transactions and Exposures with Connected Parties (issued in August 2007)</p>	<ul style="list-style-type: none"> ■ Provides greater flexibility for banking institutions to extend credit in the ordinary course of business to connected parties (previously prohibited) based on arm's length principles and subject to sound risk management practices and concentration limits.
<p>(x) Policy on Musharakah and Mudharabah Contracts (issued in September 2007)</p>	<ul style="list-style-type: none"> ■ Sets out the Bank's expectations regarding key governance, risk management and internal control functions to support the sound conduct of investment and financing transactions based on <i>musharakah</i> and <i>mudharabah</i> contracts.
<p>(xi) Guidelines on Single Counterparty Exposure Limit (concept paper issued in September 2007)</p>	<ul style="list-style-type: none"> ■ Strengthens the prudential requirements for controlling concentrated exposures to single names in line with international standards and best practices. ■ Proposed changes include the requirement to observe the limits on a consolidated basis, greater consideration of interconnected exposures based on financial and commercial interdependence, refinements to the basis for the computation of limits, and the application of permitted credit risk mitigation techniques to reduce exposures to a particular counterparty.

- (xii) Corporate Governance Standards for Licensed Islamic Banks (issued in September 2007)**
- Outlines the broad principles and minimum standards for sound corporate governance which address management oversight, accountability, audit and transparency.
 - Strengthens the Shariah compliance framework through requirements for the establishment of a Shariah committee, Shariah internal audits and enhanced disclosures relating to Shariah matters in the annual report.
- (xiii) Guidelines on Introduction of New Products (issued in November 2007)**
- Introduces a more efficient regulatory process for the offering of new products by banking institutions and development financial institutions.
 - Institutions are now allowed to offer new products in the market immediately upon submission of required information to the Bank (thereby replacing the former 21-day prior waiting period for supervisory reviews), subject to meeting the Bank's supervisory expectations set out in the guidelines.
 - A similar system will be introduced for insurers in 2008.
- (xiv) Appointment of External Auditors (issued in November 2007)**
- Addresses the responsibility of financial institutions in evaluating the integrity, objectivity and professional competence of external auditors appointed under the relevant financial sector legislation.
- (xv) Guidelines on Risk Governance (concept paper issued in December 2007)**
- Outlines high level principles on risk management governance for the board and senior management as well as supervisory expectations regarding the risk management control functions of banking institutions, insurers and takaful operators.
 - More specific risk management guidelines on credit, market and operational risks are concurrently being developed to provide further guidance on supervisory expectations in each risk area, with the concept papers expected to be released in 2008.
- (xvi) Policy on the Recognition and Measurement of Profit Sharing Investment Accounts as Risk Absorbent (issued for implementation from January 2008)**
- Islamic banks that satisfy the minimum requirements of the framework would be allowed to deduct the credit and market risk-weighted assets funded by profit sharing investment accounts from the total risk-weighted assets for the computation of the risk-weighted capital ratio, in recognition of the effective transfer of risks from the Islamic banks to the investment account holders.

The Shariah Advisory Council of the Bank also issues pronouncements on Shariah matters to be observed by financial institutions regulated by the Bank. Please refer to the box on "Shariah Pronouncements in 2007".

certain minimum standards of sound management in certain sectors which are less developed in terms of risk management sophistication (e.g. development financial institutions), where specific guidance remains necessary to build capabilities (e.g. valuation standards for takaful funds), or to address present and emerging risks (e.g. specific requirements that may be imposed under conditions of distress).

To reinforce the dynamic nature of the balance between principle- and rule-based regulations, the Bank will continue to enhance the structure of the prudential framework to provide greater clarity on the interplays between the regulations issued by the Bank. The priority will be towards developing a comprehensive set of general prudential standards which establish high level principles covering the key risk management control functions that should exist within all financial institutions. To this end, significant efforts have been taken in recent years to review and develop standards in the areas of board oversight, senior management, internal audit and risk management, which would provide the overarching prudential framework for all regulated financial institutions.

The overarching framework will be complemented by more specific prudential standards that address the Bank's supervisory expectations regarding the management of significant activities undertaken by financial institutions. These may be specific to the respective banking, insurance or takaful sectors, and may include appropriate prudential limits and more detailed requirements prescribed by the Bank. Over time, the Bank expects to evolve a more cohesive and consistently expressed prudential framework that:

- (i) addresses all the main elements of effective risk management control functions which are applicable across all significant activities of financial institutions (general standards);
- (ii) is appropriately tailored, while avoiding any overlaps, to specific areas of activity (specific standards); and
- (iii) provides for regulatory prescriptions where needed as minimum prudential safeguards.

The Bank generally expects that financial institutions would require some time to adapt to a more principle-based regime. Going forward, the pace of transition toward a more principle-based regime will depend on several key factors. The first is

a corresponding change in the behaviours of financial institutions from a focus on compliance-based outcomes, to one that focuses on the effective management of risks by institutions in an integrated manner. Greater reliance will be placed on boards to set the "tone at the top", while ensuring that there is broad-based engagement within the organisations across various levels and functions in setting risk strategy, establishing acceptable levels of risk-taking and defining accountabilities. Following from this, the Bank will expect financial institutions to have the necessary processes, systems and expertise effectively in place to support sound operating decisions and judgements, thus maintaining financial stability under the more principle-based regime.

For institutions to operate with a reasonable degree of certainty as to acceptable practices under a less prescriptive framework, there is also a need for greater dialogue between the Bank and the industry, particularly in the initial stages of transition, to build a common understanding of the range of acceptable practices and approaches which would satisfy the regulatory principles established by the Bank. The Bank will continue to actively engage the industry on this front, while ensuring consistent supervisory assessments and actions to reinforce good practices.

The Bank further envisages significant scope for the key industry associations and related professional bodies to play a more active role in promoting dialogue within the industry and providing industry-specific guidance on how principles promulgated by the Bank may be applied in practice. These entities include the Association of Banks in Malaysia, the Malaysian Investment Banking Association, the Life Insurance Association of Malaysia, the General Insurance Association of Malaysia, the Actuarial Society of Malaysia, the Malaysian Takaful Association, the Association of Islamic Banking Institutions Malaysia and the professional accounting bodies. While the Bank encourages the development of useful guidance by the industry, individual financial institutions will remain responsible for ensuring that the application of such guidance provided by the industry adequately addresses the institution's own risk exposures, having regard to the specific circumstances under which the institution operates.

RISK-BASED SUPERVISION

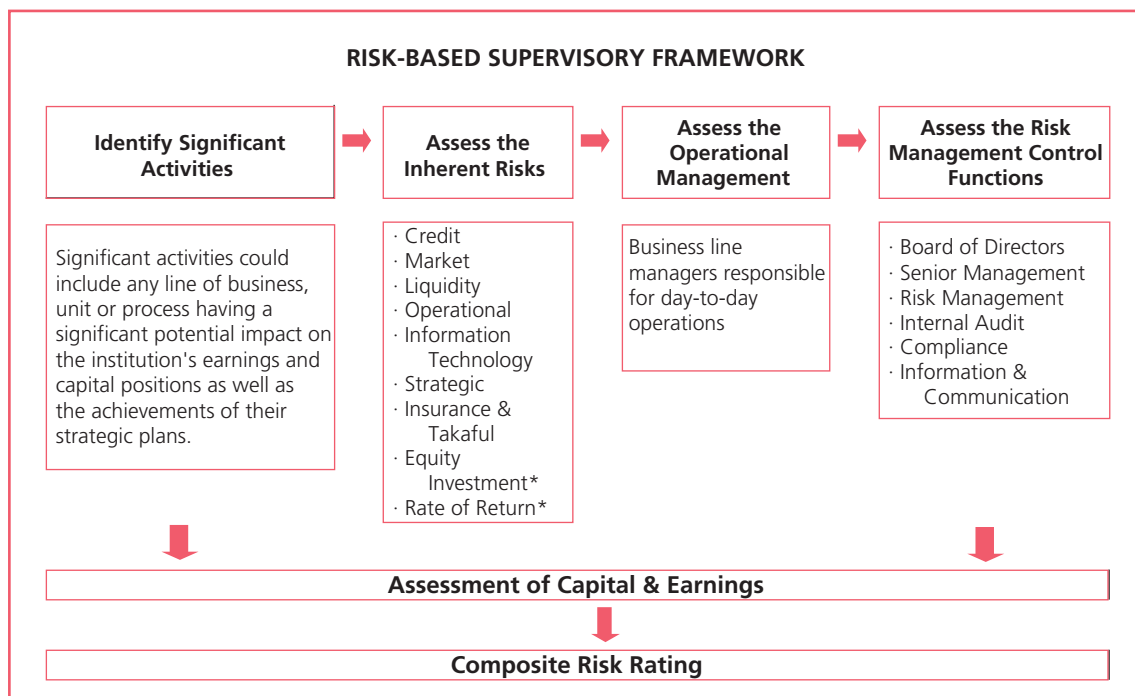
A risk-based approach to supervision has been adopted by the Bank since 1997. In 2004, an enhanced risk-based supervisory framework (RBSF)

was implemented for insurers and takaful operators, followed progressively thereafter by the adoption of the framework for banking institutions and development financial institutions. The RBSF further strengthens the Bank's risk and impact-focused approach to supervision, underpinned by more comprehensive and holistic risk assessments of individual financial institutions under the purview of the Bank. It is applied to all financial institutions regulated by the Bank, thereby ensuring that similar risks are addressed in a consistent manner across the financial sector. The framework also facilitates the appropriate concentration of supervisory attention on institutions that are of higher risk. Supervisory resources and activities are thereby more efficiently and effectively managed, with greater scrutiny on weaker and systemically important institutions.

The RBSF further strengthens the Bank's risk and impact-focused approach to supervision, underpinned by more comprehensive and holistic risk assessments of individual financial institutions.

The RBSF is a dynamic supervisory tool that identifies and assesses the emerging risks in a financial institution based on an in-depth understanding of the institution, the industry and environment in which it operates, and factors that could adversely alter the risk profile. A key output of the RBSF is an assessment (known as the composite risk rating) of an institution's ability to meet its obligations to depositors, creditors and policyholders on a continuing basis, including under stress conditions. The composite risk rating (CRR) is derived from an assessment of the risks inherent in an institution's significant activities, the overall quality of its operational management and risk management control functions to mitigate the inherent risks, and the extent of capital and earnings support available to the institution to absorb unexpected losses (Chart 4.1). The CRR provides the basis on which the Bank determines the appropriate level of intensity of supervision over a particular institution and supervisory actions, including the imposition of additional capital requirements, that need to be taken to address residual risks. The CRR is also a factor considered by the Malaysia Deposit Insurance Corporation in the application of the differential premium charges on member banking institutions for deposit insurance.

Chart 4.1 Supervisory Framework under RBSF



* For Islamic banks

The RBSF is centrally supported by "relationship managers" in the Bank whose primary responsibilities are to carry out supervisory assessments of institutions, conduct ongoing supervisory reviews, recommend appropriate interventions and maintain open lines of communication with the institutions to ensure that developments – both internal and external to the institutions – are quickly identified and factored into supervisory assessments on a continuing basis.

Based on the Bank's supervisory assessments under the RBSF, the vast majority of financial institutions remained in a healthy position as at end-2007, with the capacity to manage the increased risks associated with the more volatile external environment.

During the year, the Bank continued to strengthen the supporting structure, processes and core capabilities required to effectively implement the RBSF through:

- the institution of a quality assurance framework which provides for more rigorous internal processes to promote accurate risk assessments and feedback across the Bank's supervisory departments, as well as timely and effective interventions. Among other things, the framework provides for internal peer reviews of supervisory assessments to validate the judgements exercised by relationship managers in respect of individual institutions. These panel reviews ensure that supervisory assessments are appropriate, having regard to the supervisory expectations established in guidelines issued by the Bank, the institution-specific exposures and risk management practices, and assessments of other institutions with similar risk profiles;
- significantly strengthened technical capabilities residing in specialised risk (credit, market, operational and insurance) and econometrics units established within the Bank. These units are staffed by qualified supervisors and subject matter experts who provide key support to the relationship managers on more technical aspects associated with statistical modelling, complex risk assessments and the evaluation of internal risk models; and
- improved supervisory information systems and infrastructure with enhanced capabilities to support more efficient supervisory assessments.

In implementing the RBSF, the Bank has also enhanced its supervisory documentation to ensure that supervisory assessments are well-supported, and provide a clear trail of risk issues, developments and actions taken in relation to each individual institution. Greater integration between the Bank's macro-surveillance and supervision functions was also achieved with enhanced two-way flows of information that provided supervisors with up-to-date developments of emerging risks within the broader financial system that could impact the risk profile of individual institutions, while institution-specific insights from supervisors contributed towards a deeper understanding and more effective monitoring by the Bank of potential risks to financial stability.

Greater integration between the Bank's macro-surveillance and supervision functions was also achieved with enhanced two-way flows of information that provided supervisors with up-to-date developments of emerging risks.

Under the RBSF, greater reliance is placed on an institution's internal oversight functions to identify emerging risks and safeguard an institution's financial condition. To support such reliance, the Bank has continued to regularly engage the board and senior management as well as those principally responsible for internal audit, risk management, compliance and management information support within institutions, on risk issues concerning the institution. Greater reliance is also placed by the Bank on the work of external auditors and actuaries appointed by financial institutions. In this connection, the Bank has regular discussions with external auditors and actuaries to enhance awareness and clarity of the Bank's expectations of their roles, and the degree of reliance placed on their work for supervisory purposes.

ENSURING A COHESIVE PRUDENTIAL AND SUPERVISORY FRAMEWORK

The framework for prudential regulation and supervision is both interdependent and mutually reinforcing. In implementing the RBSF and more

principle-based approach to regulation, significant attention is directed at ensuring the effective integration of the regulatory and supervisory processes to achieve a coherent framework that contributes to financial stability.

Significant attention is directed at ensuring the effective integration of the regulatory and supervisory processes to achieve a coherent framework that contributes to financial stability.

In line with the transition from a "one-size-fits-all", compliance-focused regulatory regime, to one that is more differentiated according to risk and more reliant on the exercise of supervisory judgements, enhanced processes have been adopted to further integrate critical supervisory inputs into policy thinking and formulation. Specifically:

- prudential policy priorities are confirmed against key risks to financial stability highlighted through supervisory observations and assessments;
- policy development is jointly approached between the regulatory and supervisory functions of the Bank, thus allowing for broader-based assessments of proposed policies while ensuring a common understanding of the specific outcomes of prudential policies. This, in turn, facilitates supervisory assessments of individual institutions under the RBSF that will be aligned with, and reinforce, the supervisory expectations set out under the principle-based regulations; and
- the exercise of sound supervisory judgement is further reinforced through the inclusion of staff involved in policy development in the supervisory review panels and intervention deliberations. This further contributes towards ensuring that supervisory assessments and interventions are appropriate, having regard to specific outcomes intended by the prudential standards issued.

During the year, the Bank also completed an assessment of revisions to the legislation applied

to financial institutions under the Bank's purview to ensure an enabling legislative framework that is supportive of the more principle-based regulatory approach as well as risk-based supervision. More than 166 provisions of the Banking and Financial Institutions Act 1989 and the Insurance Act 1996 were reviewed with the aim of:

- aligning the legal provisions with the more principle-based regulations and developments in international supervisory standards;
- ensuring that the Bank will have the necessary authority to act under the risk-based approach to supervision when necessary;
- enhancing cross-sector consistency;
- enhancing clarity of the law; and
- reducing the administrative burdens on financial institutions where appropriate.

The Islamic Banking Act 1983 and Takaful Act 1984 have also been concurrently reviewed together with an exercise to update and strengthen these respective legislations. The Bank expects to complete the legislative process to effect these amendments in 2008.

To ensure the efficiency and integrity of the prudential framework, the Bank made further progress in efforts to rationalise and update the prudential framework across the industries regulated by the Bank, as well as in relation to the capital market intermediaries regulated by the Securities Commission. During the year, the Bank completed an exercise to identify divergent regulatory requirements in common areas of activity involving its regulated institutions, reviewed 18 regulatory requirements and identified a further 14 areas for review in 2008.

The Bank continued to obtain relevant input from the financial industry and other key stakeholders to maintain a robust framework that is reflective of changing market realities and is implementable in practice. During the year, six concept papers were issued to the industry, with another eight in the final stages of completion for expected issuance within the first half of 2008. Responses received from stakeholders continued to provide important insights into the efficiency implications of proposed policies, consistency across industries as well as their likely impact on business and financial activities. Where appropriate, policies were modified to address significant issues raised.

The Bank remained mindful of the trade-off between the benefits and costs of regulation. As in previous years, a large part of feedback received during the consultation process highlighted the concerns of institutions regarding practical implementation issues. The Bank held dialogues with the industry and individual institutions to understand these concerns more fully and develop implementation solutions that appropriately balanced the costs of implementation with risks to financial stability. In an environment of increased volatility and competition, however, financial institutions clearly recognised the urgent need to enhance risk management systems and governance structures within their organisations.

Outside the Bank, closer coordination with other regulatory and supervisory agencies was also achieved with the conclusion of formal agreements with the Securities Commission and the Malaysia Deposit Insurance Corporation that clearly set out the roles, responsibilities and cooperation arrangements aimed at minimising regulatory overlaps and inconsistencies. The arrangements have continued to work well in enhancing regulatory efficiency and facilitating the sharing of information between agencies where appropriate. The Bank also signed a Memorandum of Understanding with the State Bank of Vietnam to facilitate greater cross-border supervisory collaboration.

Supervisory cooperation at the regional level deepened further.

At the regional level, supervisory cooperation through the various regional groupings of which the Bank is a member, such as the Executive Meeting of East Asia and Pacific Central Banks (EMEAP) and South East Asian Central Banks (SEACEN), deepened further. Cooperation focused in particular on facilitating the implementation of Basel II within the region as well as strengthening the regional frameworks for macro-surveillance and crisis management. During the year, the Bank also maintained its commitment to strengthen the region's influence in the development of international standards through its participation in various working groups, and by providing feedback on more than 15 draft standards and surveys issued by the international standard setting bodies.

IMPLEMENTATION OF REVISED CAPITAL ADEQUACY FRAMEWORKS

During the year, substantial progress was achieved in final preparations for the implementation of the revised capital adequacy frameworks for banking institutions and insurers. The revised frameworks will align regulatory capital requirements more closely with the specific risk profiles of individual institutions and adopt underlying valuations that are consistent with international financial reporting standards.

Revised Risk-Weighted Capital Adequacy Framework (Basel II) for Banking Institutions

The revised risk-weighted capital adequacy framework (Basel II), which is applicable to commercial banks and investment banks, became effective from 1 January 2008 for a total of 27 banking institutions that are adopting the simpler approaches, namely the Standardised Approach for credit risk and either the Basic Indicator, Standardised or Alternative Standardised Approaches for operational risk. The remaining seven banking institutions (including four locally-incorporated foreign banking institutions) have been allowed to remain under the existing capital adequacy framework (Basel I) until their migration to the more advanced Internal Ratings-Based (IRB) approaches for credit risk under Basel II from 1 January 2010. The option for direct migration which is intended to minimise the cost of Basel II implementation, was granted only to banking institutions that had met preconditions set by the Bank, such as the availability of resources and expertise to meet the supervisory expectations under IRB approaches as well as the ability to demonstrate a high level of commitment and discipline in implementation preparations.

With respect to Islamic banks, 10 out of 12 Islamic banks have adopted the revised framework for Islamic banks (Capital Adequacy Framework for Islamic Banks or CAFIB) which specifies the standardised approach to capital computations, while reflecting the differences in the underlying contracts and incorporating specific elements peculiar to Islamic banking such as the capital requirements for inventory risks as well as the treatment of profit sharing investment accounts. The remaining two Islamic banks have been allowed to migrate directly to the IRB approach in January 2010.

The Bank anticipates that most banking institutions would experience only modest

increases in their regulatory capital requirements following the adoption of the revised capital frameworks, based on results from the parallel run exercise in 2007. While the revised frameworks introduce a new operational risk charge, the anticipated additional capital requirements are expected to be partly mitigated by savings on the credit risk capital charge derived from the lower risk weights applied for residential mortgages and retail exposures. In this connection, there has been greater emphasis for banking institutions to improve the collection of data on operational losses. While this is not a pre-requisite for the implementation of the Basic Indicator Approach under the revised frameworks, the Bank views the collection of loss data as critical in allowing banking institutions to better understand their operational risk profiles as a basis for the development of enhanced operational risk management capabilities.

For some institutions, the ability to quantify the effects of comprehensive credit risk mitigation techniques used, and the holdings of a significant portion of investment-grade debt securities, would generate further capital savings. The parallel run calculations also indicated a minimal impact on capital arising from the revised requirements for market risk which, among other things, incorporate a new capital requirement for commodity risk positions and recognise offsetting liability positions in the trading book. For Islamic banks, the inclusion of physical assets as eligible collateral and the recognition of profit sharing investment accounts as a risk absorbent under the revised framework would also allow for additional capital relief.

Most banking institutions would experience only modest increases in their regulatory capital requirements following the adoption of the revised capital frameworks.

For banking institutions that have been allowed to migrate directly to the IRB approaches, significant attention and resources have been directed towards the proper construction of risk and data management systems and infrastructural enhancements, as well as strengthening the

internal risk modelling and analytical capabilities. The Bank will monitor these preparations closely to ensure that these banking institutions remain on track to comply with the IRB approaches by 2010.

Risk-Based Capital (RBC) Framework for Insurers

The Risk-Based Capital (RBC) framework was issued to the insurance industry in April 2007. The framework provides for regulatory capital requirements that are more sensitive to the underlying risk exposure of insurers, compared to the existing solvency requirements. This allows for more flexible investment rules, while introducing revised valuation requirements that are market consistent. All insurers are currently conducting a parallel run exercise in preparation for the effective implementation of the framework in January 2009.

While the Bank anticipates some increase in capital requirements among several insurers, the parallel run exercise indicated that the majority of insurers would be able to comfortably meet the minimum regulatory capital requirement. While insurance risk contributed most significantly to the overall regulatory capital requirement, market risk also represented a significant source of risk for life insurers, mainly associated with equity exposures and interest rate mismatches.

The majority of insurers would be able to comfortably meet the minimum regulatory capital requirement.

The adoption of market consistent valuations of assets and liabilities may also result in some increased volatility in the financial results of insurers. For life insurers in particular, the insufficient volume of long-term debt instruments in the domestic market currently, coupled with the prevailing low interest rate environment, has continued to place some pressure on guaranteed business, resulting in higher exposures to asset-liability mismatch risks. However, most insurers should experience only modest increases in volatility as asset positions adjust proportionately against corresponding liability positions.

PRIORITIES IN 2008

Bank Negara Malaysia's regulatory and supervisory priorities in 2008 will continue to

focus on strengthening the Bank's capabilities and capacity to respond pre-emptively to emerging risks in the financial system. This would include:

- ensuring that regulatory requirements continue to remain appropriate over time and in relation to the changing environment, as well as clearly setting out the Bank's supervisory expectations with regard to the management of key risks;
- ensuring, through vigilant supervision, that institutions are adequately managing their risks in practice in line with the supervisory expectations of the Bank; and
- continuously building capacity within the Bank to support both of these activities.

The implementation of the revised capital frameworks for the banking and insurance industries will remain a key priority in 2008. Banking institutions which have been granted approval to adopt the IRB approaches for credit risk will be required to submit their internal models to the Bank for review before the models can be used to determine regulatory capital requirements. Significant supervisory resources will be devoted to the review and validation of these models ahead of the 2010 deadline for implementation of the IRB approaches. The Bank will also continue to closely monitor the quantitative impact of regulatory capital adjustments within institutions and across the industry for both banking institutions adopting the standardised approaches and insurers applying the RBC framework on a parallel run basis in 2008. The Bank expects to provide greater clarity to the industry on its approach to the determination of additional capital requirements under the supervisory assessment process (Pillar 2) for specific institutions, as well as advance forward its work on market disclosures to reinforce sound financial management (Pillar 3). Remaining

implementation and calibration issues surrounding the revised frameworks will also be resolved. The Bank further intends to initiate work to develop an equivalent RBC framework for the takaful operators.

The implementation of the revised capital frameworks for the banking and insurance industries will remain a key priority in 2008.

Other priorities for the Bank in 2008 are the completion of reviews of the relevant financial sector legislation to reinforce the Bank's new approaches to regulation and supervision; development of a revised and more cohesive compendium of risk management standards; and preparations for the implementation of international financial reporting standards on financial instruments and insurance contracts. The Bank also expects to engage the industry on the proposed approach to the supervision of financial groups, focusing in particular on the application of the revised capital adequacy frameworks and the RBSF in the context of financial groups.

Another priority will be in the area of corporate governance. While the Bank does not envisage substantive changes to its current set of principles applicable to financial institutions, further efforts will be taken to harmonise standards across institutions regulated by the Bank and, to the extent appropriate, with the updated requirements under ongoing reforms to the Companies Act 1965 and developments in national codes of corporate governance. The Bank also expects to take forward initiatives in the area of directors' education which are aimed at supporting effective board functions.

Shariah Pronouncements in 2007

The Shariah Advisory Council (SAC) is the sole authoritative body on Shariah matters pertaining to Islamic banking, takaful and Islamic finance. Its jurisdiction covers all financial institutions regulated and supervised by Bank Negara Malaysia. As the reference body and advisor to the Bank on Shariah matters, the SAC is also responsible for validating all Islamic banking and takaful products to ensure compatibility with Shariah principles.

In 2007, the SAC convened 12 meetings and among its major decisions were:

(i) Application of *Ijarah Mausufah fi Zimmah* in house financing

The SAC approved the application of *ijarah mausufah fi zimmah* (forward lease) as a supporting contract in house financing based on *ijarah* as the primary contract. The decision bears particular significance for the financing of uncompleted assets as it will resolve the issue of rental payments made for the period commencing from the execution of the contract to the completion of the asset. Prior to the decision, rental charges for the period before completion of the asset were not justifiable as the tenant could not enjoy the usufruct during this interim period. With the application of the forward lease, however, such payments can be treated as future rentals. The decision has been recognised by scholars from different schools of thought and will further refine existing contracts incorporating Shariah principles.

(ii) Application of *Wakalah bi Istithmar* contract

The SAC also approved the application of the *wakalah bi istithmar* (agency for investment) contract in deposit accounts. This contract involves deposit-taking mobilised through *wakalah* (agency), in which the funds mobilised are invested in instruments that would generate an agreed minimum rate of return. In contrast to deposits mobilised through *wadiah* or *qardh*, the *wakalah* contract feature would allow Islamic financial institutions to offer additional benefits such as takaful coverage with *wakalah* deposit accounts to enhance the product's attractiveness to customers. However, the implementation of such contracts must be carried out prudently to avoid any element of guarantee by the agent on the investment returns. The resolution by the SAC is expected to further diversify Shariah-compliant products and at the same time allow Islamic banks to be more creative and innovative in their product offerings.

Recognising the importance of Shariah compliance in Islamic finance, Bank Negara Malaysia, in March 2007, published a compilation of resolutions made by the SAC in a book entitled "Shariah Resolutions in Islamic Finance". The book is intended to serve as a reference for the Islamic finance community, especially Shariah officers and practitioners. To inform the market in a timely manner, the Bank has also disseminated recent resolutions made by the SAC through press releases as part of its continuing effort to increase transparency and enhance the understanding of Shariah issues among market players.

To promote quality research on Shariah compliance while improving regulatory efficiency, the presentation of Shariah issues and new product proposals by Islamic banks to the SAC are required to be submitted in a standard format which incorporates issues, opinions and views of renowned Shariah scholars. Institutions offering Islamic products are also required to state clearly the views of the institutions' Shariah committee and the rationale behind such views. This will contribute towards deepening the understanding of the issues being discussed, thus promoting sound Shariah resolutions.

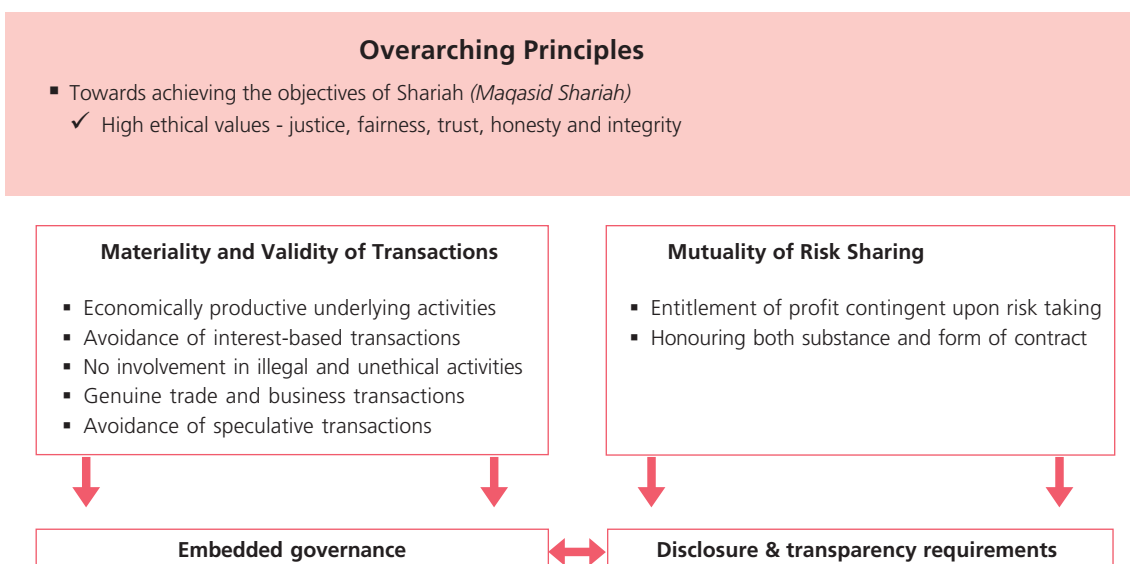
The SAC is supported by Shariah research carried out by Bank Negara Malaysia on Shariah aspects of product innovations as well as on immediate and long-term policy issues. In 2007, research undertaken on the application of the *wakalah bi istithmar* concept in savings deposit products supported the approval given by the SAC for this product, considered the first *wakalah*-based savings product in the world. The Bank also conducted research to establish the applicability of existing financial reporting principles as a guide to develop Islamic financial reporting standards. Based on the Bank's research, the SAC pronounced that these principles are consistent with Shariah and can serve as guiding principles to develop similar standards for Islamic financial reporting. The SAC also highlighted the need for existing financial reporting standards to be enhanced in order to support Shariah requirements.

Distinct Features of Islamic Financial Transactions: Perspective on *Musharakah Mutanaqisah* (Diminishing Partnership)

"The very objective of the Shariah (**Maqasid Shariah**) is to promote the welfare of the people which lies in safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves public interest and is desirable." - Al Ghazali

Islamic finance is founded on Shariah principles which express an explicit intention to meet the financial needs of participants with integrity and in a manner that is just, fair, trustworthy and honest, while ensuring a more equitable wealth distribution. Chart 1 briefly summarises the essential features of Islamic finance.

Chart 1
Essential Features of Islamic Finance



Unlike conventional finance, Islamic finance is governed by Shariah rules that prohibit interest-based transactions. Islamic financial transactions are also required to be accompanied by genuine underlying trade and business activities that generate fair and legitimate profits. This reinforces the close link between financial and productive flows which underpin Islamic finance, thereby insulating the Islamic financial system from risks associated with excessive leverage and speculative financial activities. The risk- and profit-sharing characteristics of Islamic financial transactions (such as in *mudharabah* and *musharakah* contracts) which are clearly defined at the onset, serve as additional in-built mechanisms that further strengthen incentives for the adoption of sound risk management practices by Islamic financial institutions. In particular, these features demand the exercise of appropriate due diligence by Islamic financial institutions and higher standards of disclosure and transparency to be observed which, in turn, act to enforce market discipline and minimise informational asymmetries.

Collectively, these intrinsic features and requirements of Islamic finance act as natural stabilisers and restraints against the risks and excesses associated with excessive leverage, financial speculation and mis-selling that can threaten the effective functioning of financial systems.

The range of Islamic financial products has broadened considerably in recent years in response to the more diverse and differentiated requirements of participants. For example, Islamic financing contracts have expanded from simple-mark up contracts to include those that are equity-based. While Islamic finance has continued to evolve rapidly, the distinct features of Islamic financial transactions have been preserved in the new innovations in order to ensure that the religious and ethical principles of participants are not compromised. This is illustrated in the following example of *musharakah mutanaqisah*, an equity-based contract which has been widely accepted in many jurisdictions.

A Study on *Musharakah Mutanaqisah*

Musharakah mutanaqisah – A form of partnership in which one partner promises to gradually acquire the equity share of the other partner until the share of ownership is completely transferred to the first partner.

Musharakah mutanaqisah can be applied in home financing products. Based on the joint-ownership concept, the banking institution and the customer contribute their respective shares of the capital required to acquire the property according to a pre-determined ratio agreed to between them at the beginning of the contract. The banking institution leases the property to the customer who undertakes to incrementally acquire the full ownership of the property from the banking institution over an agreed period. Once the customer has fully acquired the banking institution's share of the property, the partnership comes to an end with the customer becoming the sole owner of the property. This contract incorporates elements of both sale and lease (*ijarah*) contracts, which are integral in ensuring that no element of *riba* (interest) is involved in the *musharakah mutanaqisah* transaction. The dynamics, at different transaction stages, of a *musharakah mutanaqisah* contract for completed property is illustrated in Chart 2.

The application of Shariah principles in *musharakah mutanaqisah* contracts creates distinct relationships, rights and obligations of the parties to the contracts. As a result, banking institutions are exposed to both market risk associated with the joint ownership of the underlying asset, as well as credit risk associated with the obligation on the part of the customer to acquire, and on the banking institution to sell, its share of ownership in the asset. This distinct risk exposure requires the banking institution to adopt more robust methodologies supported by reliable and adequate data and systems that are able to detect and provide best estimates of potential losses arising from adverse developments in the credit profile of the customer. The risk management processes and infrastructure of a banking institution offering such a product must also be dynamic in identifying, measuring, controlling and managing all the relevant risks associated with *musharakah mutanaqisah* transactions. Chart 3 shows the key risk exposures and risk management practices at the different stages of a transaction in *musharakah mutanaqisah*, as well as additional risk mitigants that can be introduced.

Chart 2
Dynamics of *Musharakah Mutanaqisah* Contract for Completed Property

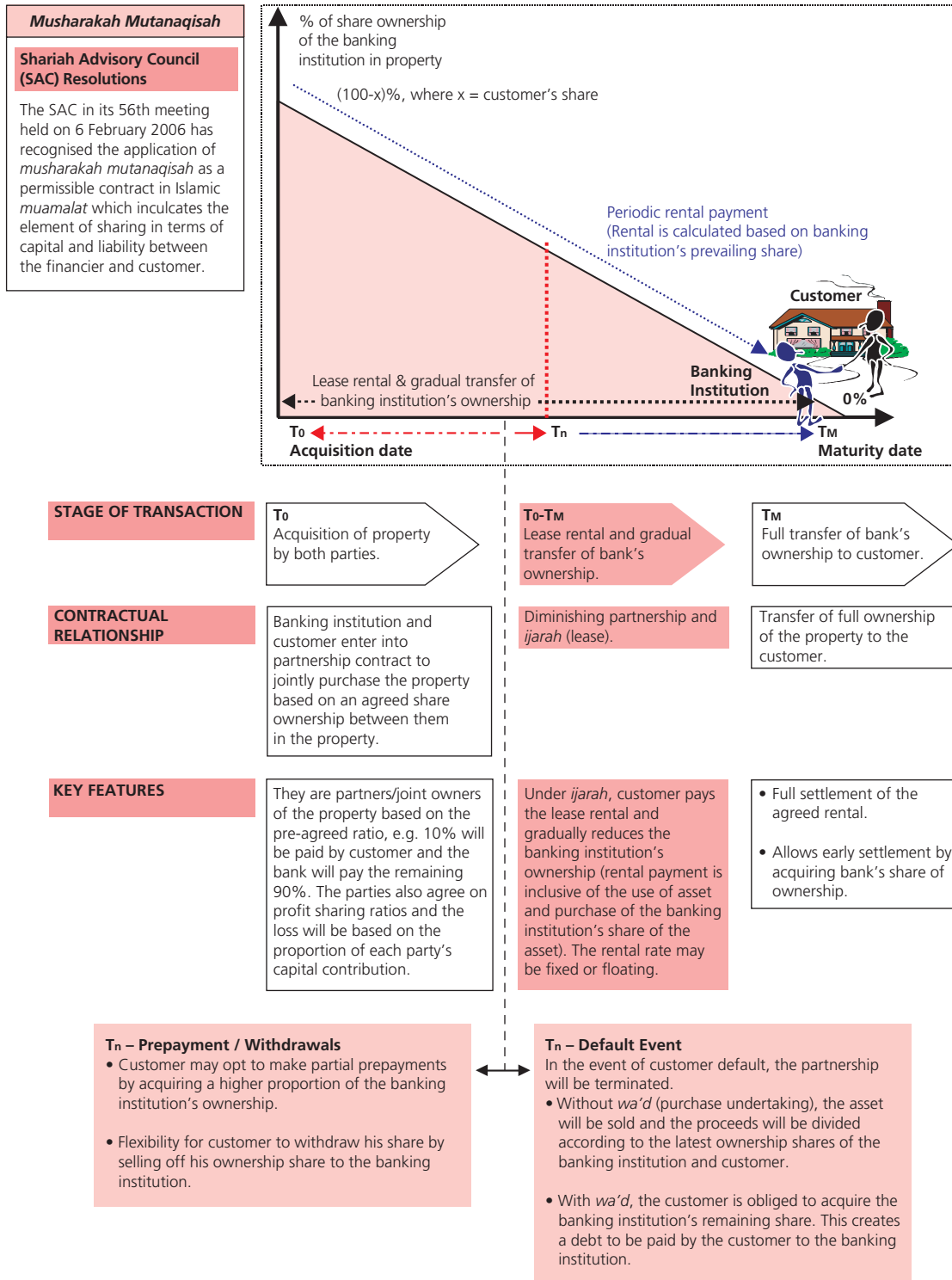
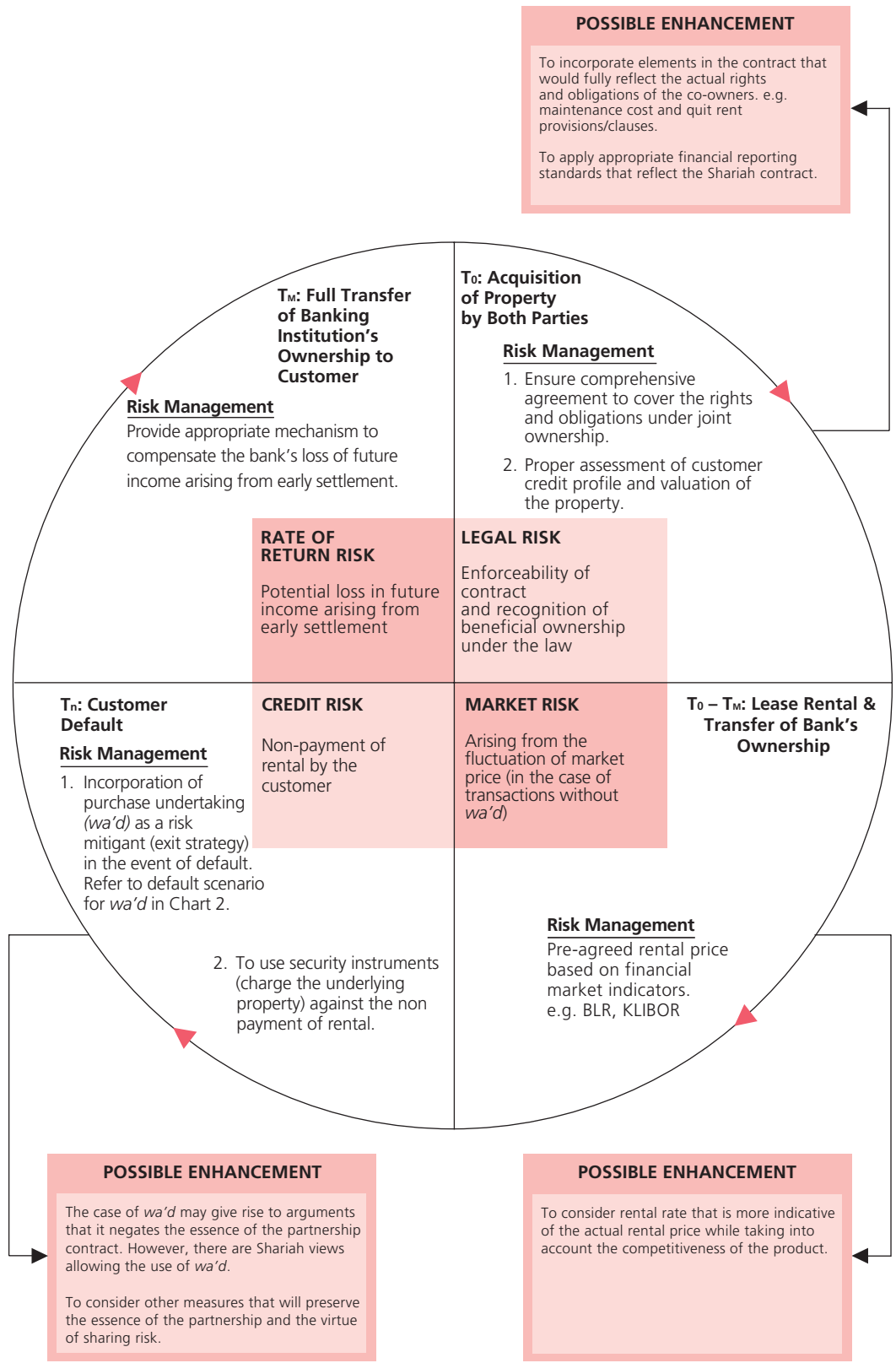


Chart 3
Management of Key Risks in *Musharakah Mutanaqisah* Contracts



Several jurisdictions have also applied specific regulatory requirements to ensure the appropriate management of risks associated with this type of contract. For example, in jurisdictions adopting capital adequacy frameworks based on the Capital Adequacy Standard issued by the Islamic Financial Services Board, Islamic banking institutions are required to allocate sufficient regulatory capital to cover the exposures to both the price risk based on the proportion owned by the banking institution in the underlying assets, as well as the credit risk arising from the outstanding rental payable by the customer. In tandem with the banking institutions' diminishing share of ownership in the asset, the capital requirement for the price risk would gradually decline over the period of contract.

With its distinct features, and in-built checks and balances, the development of Islamic finance as a viable form of financial intermediation is expected to contribute towards enhancing financial stability. Moving forward, further product innovations in Islamic finance can be expected. This needs to be supported by further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging in order to ensure that the fundamental tenets of Shariah which underpin the stabilising factors inherent in Islamic financial transactions, are preserved.