

## **Malaysia: Report on the Observance of Standards and Codes**

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MALAYSIA

REPORT ON THE OBSERVANCE  
OF STANDARDS AND CODES  
(ROSCs)

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**GLOSSARY**

AML/CFT	Anti-Money Laundering/Counter Financing of Terrorism
BAFIA	Banking and Financial Institutions Act 1989
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles
BFF	Bridge Financing Facility
BM	Bursa Malaysia
BMD	Bursa Malaysia Derivative Berhad (the derivatives exchange)
BMDC	Bursa Malaysia Derivative Clearing
BMDepo	Bursa Malaysia Depository Sdn Bhd (the central depository)
BMS	Bursa Malaysia Securities Berhad (the stock exchange)
BNM	Bank Negara Malaysia
CAR	Capital Adequacy Ratio
CBA	Central Bank of Malaysia Act 2009
CCP	Central Counterparty
GDG	Government Deposit Guarantee
CGF	Clearing Guarantee Fund
CME	Chicago Mercantile Exchange
CMSA	Capital Markets and Services Act 2007
CPs	Core Principles
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
DIS	Deposit Insurance Scheme
DFI	Development Finance Institution
DPS	Differential Premium System
DVP	Delivery versus Payment
FHC	Financial Holding Company
FMI	Financial Markets Infrastructure
FRS	Financial Reporting Standards
FSA	Financial Services Act
FSAP	Financial Sector Assessment Program
FSEC	Financial Stability Executive Committee
FSPSR	Financial Systems and Payment Systems Report
IBA	Islamic Banking Act 1983
ICAAP	Internal Capital Adequacy Assessment Program
IDIF	Islamic Deposit Insurance Fund
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRB	Internal Rating Based
LFSA	Labuan Financial Services Authority
MASB	Malaysian Accounting Standards Board

MI	Member Institution
MoF	Ministry of Finance
SC	Securities Commission Malaysia
NPL	Non-Performing Loan
PDS	Private Debt Securities
PIDM	Malaysia Deposit Insurance Corporation
PFMI	CPSS-IOSCO Principles for Financial Markets Infrastructure
RM	Malaysian Ringgit
RENTAS	Real Time Electronic Transfer of Funds and Securities
ROSC	Report on Observance of Standards and Codes
RTGS	Real Time Gross Settlement System
RTO	Recovery Time Objective
SAA	Strategic Alliance Agreement
SBL	Securities Borrowing and Lending
SC	Securities Commission Malaysia
SCA	Securities Commission Act 1993
SKM	Cooperatives Commission
SME	Small and Medium Enterprises
SRU	Specialist Risk Unit
SSS	Securities Settlement System
SuRF	Supervisory Risk Based Framework
TIPS	Takaful and Insurance Benefits Protection System

## I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

### A. Summary

1. **This assessment of the current state of compliance with the BCPs in Malaysia has been undertaken as part of a joint IMF-World Bank Report on the Observance of Standards and Codes (ROSC) mission.**<sup>1</sup> The assessment was conducted in April 2012. It reflects the banking supervision practices of the Bank Negara Malaysia (BNM) as at end-March 2012.
2. **BNM employs a very well developed risk-focused regulatory and supervisory regime, consisting of a hands-on and comprehensive program of onsite supervision and extensive off-site macro and micro surveillance that is well integrated with its on-site supervision.** BNM supervisors are guided and assisted by a generally well articulated set of risk management and internal control expectations, specified higher than international minimum capital requirements, a comprehensive liquidity risk framework, and effective coordination and information sharing with foreign supervisory authorities.
3. **There remain, however, several opportunities to improve the regulatory and supervisory framework. New financial services legislation, the Financial Services Act (FSA), seeks to address many of these gaps.**<sup>2</sup> For instance, a clear gap exists in the application of the supervision and regulation regime to financial holding companies (FHCs). Six of the eight large domestic banking groups have parent FHCs and the current legislative framework does not by its terms apply to those firms on a parent or consolidated basis. The BNM has been creative by imposing conditions on the FHCs, using legislative authority applicable to affiliates of banks to apply reporting and examination requirements to the FHC and its subsidiaries. More detailed regulation would be useful on interest rate risk in the banking book, credit concentrations, country risk, and operational risk. The transparency of the criteria applied for new licenses and for acquisitions could be improved. Finally, there are exit opportunities to better focus the information sharing arrangements with the SC and strengthening the legal protection available for supervisors. There are also some broad policy issues on the relationship between BNM and MOF, and between BNM and the Malaysia Deposit Insurance Corporation (PIDM) that should be reviewed.

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<sup>1</sup> The assessment was conducted by William Rutledge (consultant to the IMF) and Katia D'Hulster (World Bank staff).

<sup>2</sup> The FSA was passed in December 2012; implementation will follow Royal Assent, probably by mid-2013.

## B. Institutional Setting and Market Structure Overview

4. **The banking sector, which accounts for half the financial system, is well capitalized and profitable.** The onshore banking sector—with assets of some 200 percent of GDP—comprises nearly 50 percent of financial sector assets (Islamic banks are around 20 percent of the banking sector) and Labuan IBFC banks an additional 3 percent. The top 5 domestic banking groups comprise nearly 62 percent of total banking system assets. The banking sector's asset quality remained healthy with steady improvement in gross NPL ratios to 2.7 percent in 2011. Total provisions (general and specific) were 99.4 percent of NPLs; NPLs net of specific provisions stood at 1.8 percent. Banks remain well capitalized with system-wide risk-weighted capital ratio and core capital ratios at 15.6 percent and 13.6 percent respectively in 2011.

5. **Non-bank credit intermediation is sizable, at some 90 percent of GDP.** This is accounted for predominantly by the state-run Employee Provident Fund, insurance companies, and DFIs. The EPF and insurance companies invest the majority of their portfolios in the domestic bond market, in both government and private debt securities. DFIs provide credit via direct lending to targeted sectors such as agriculture, SMEs, infrastructure, maritime, export-oriented sector, high-technology and capital-intensive industries. They are well capitalized.

## C. Preconditions for Effective Banking Supervision

6. **The legal framework in Malaysia is based on a common law legal system.** Laws are enforced through a single structured judicial system consisting of superior and subordinate courts whose decisions are enforceable, with avenues for appeal consistent with common law systems. In addition to the court system, alternative mechanisms for resolving disputes and debts also exist. These include arbitration, mediation, credit counseling, and debt management and restructuring services.

7. **Accounting and auditing services are well developed and provide a sound basis for credible disclosure and resultant market discipline.** Companies are required to prepare their accounts based on approved accounting standards issued by the Malaysian Accounting Standards Board (MASB). Public interest entities (including banking institutions) are required to report their accounts using Financial Reporting Standards set by the MASB, which is in compliance with IFRS both in terms of content and timing of implementation. Companies' accounts are required to be audited annually by approved auditors. Reports and the audit procedures performed are in compliance with the National Auditing Standards, which are in full compliance with the International Standards on Auditing.

8. **The Malaysian Electronic Clearing Corporation, a wholly owned subsidiary of BNM, operates RENTAS, a real time gross settlement system for interbank funds transfer, a securities settlement system and a securities depository for all unlisted debt**

**instruments.** RENTAS is also linked with the USD Clearing House in Hong Kong to mitigate for settlement risk for Ringgit-USD foreign exchange transactions.

9. **The credit information services industry in Malaysia consists of agencies from both the public and the private sector.** The Centralized Credit Reference Information System is operated by BNM. It collects and disseminates credit information from and to participating financial institutions. Private sector credit reporting agencies include Credit Bureau Malaysia, RAM Credit Information, Financial Information Services and CTOS and are regulated by the Registrar of Credit Reporting Agencies.

10. **The deposit insurance system is administered by the PIDM and provides coverage for conventional and Islamic deposits, for all type of depositors, whether business or individuals.** The maximum limit of coverage is RM 250,000 per depositor per member institution. All commercial and Islamic banks, domestic and foreign, are member institutions of PIDM and are subject to a risk based differential premium system.

11. **BNM has a broad range of powers to avert or reduce risks to financial stability.** These include intervention and resolution measures, with powers to reduce systemic risks emanating from both regulated and non regulated entities and to stem institutional or market liquidity shocks. In addition to the operational standing credit facility for banks to obtain overnight liquidity, BNM has broad powers to provide liquidity assistance to any financial institution through a range of instruments. A Financial Stability Committee (FSC) serves as BNM's internal high level forum responsible for discussing risks to financial stability and deciding on the appropriate policy responses.

### **Box 1. Islamic Banking in Malaysia**

Islamic banking refers to a system of banking that complies with Shariah law. Malaysia has recorded robust growth in Islamic banking assets. Total assets in the Islamic banking sector (including DFIs) accounted for 22.4% of total banking system assets as at end-2011. In Malaysia, Islamic banking is mostly conducted through separately incorporated banks. The 16 Islamic banks include ten which are domestically owned and six which are foreign owned. Licensed commercial and investment banks are also given the flexibility to operate an Islamic banking window, subject to meeting applicable standards and guidelines to ensure full Shariah compliance – to date there are three commercial Islamic banking windows and seven investment banking windows.

In a dual financial system in which conventional and Islamic financial products are offered in parallel, a critical aspect of the regulatory framework is the consistency of rules and regulations across both sectors to eliminate possibilities for regulatory arbitrage. At the same time, there is a need to reflect the differences in the nature of risk inherent in Islamic financial products and services. Shariah requirements are observed in the formulation of applicable standards through active involvement of the Shariah unit and consultation with the Shariah Advisory Council on Islamic Finance established under the CBA 2009 (SAC) on any matters requiring ascertainment of Islamic law.

The supervisory approach and practices for Islamic banks at the BNM are very similar to commercial banks. The only major difference is that, in accordance with the risk based supervisory framework, an additional operational risk i.e. that of Shariah compliance, is assessed for Islamic banks. This risk is analyzed in two ways;

### **Box 1. Islamic Banking in Malaysia (concluded)**

first, as a compliance risk embedded in every significant activity, second as an overarching operational risk for the whole bank. To assist with the specific detailed aspects of the assessment, a team of Shariah officers including a Shariah compliance expert employed in the BNM Specialist Risk unit provides input.

The Islamic banks are governed by a separate Act (the Islamic Banking Act 1983 (IBA)). In some areas, the IBA provides less legislative authority than the more recent Banking and Financial Institutions Act 1989 (BAFIA) which governs the conventional banks. The authorities state that effective implementation of a comparable prudential framework has been conducted through guidelines issued pursuant to the general power to issue guidelines under IBA and setting clear supervisory expectations on Islamic banks. Although the assessors have not focused on Islamic banking, the BNM is confident that in practice it ensures consistent rules and regulation across both sectors. There remain some areas where the legal and regulatory requirements as well as the powers of the BNM are not formalized in the IBA.

For example

- The lack of explicit power for the BNM to revoke licenses for Islamic banks; The IBA does not have a provision that allows the MOF, on recommendation of the BNM, to revoke a license granted when BNM has been provided with false, misleading or inaccurate information in connection with the application or after the grant of a license. Instead BNM may rely on contravention of any provision of the IBA for revocation.
- Unlike BAFIA, there is no specific share ownership threshold driving the need for an application in the IBA; however by regulation BNM has imposed the same 5 percent threshold.
- The IBA does not currently require external auditors to report matters of material significance to the supervisor, for example failure to comply with the licensing criteria or breaches of banking or other laws or other matters which they believe are likely to be of material significance.
- The lack of explicit power to obtain information from the holding companies of Islamic banks. Hence, the BNM cannot currently conduct any examinations of holding companies or require holding companies, controllers or significant owners or any group or related entities to provide information to BNM for supervisory purposes. Most Islamic banks are held directly by a regulated banking institution; but one Islamic bank is not part of a commercial banking group and is held by a holding company. The BNM is of the opinion that it has been able to obtain relevant information relating to the holding company from the Islamic banks.
- The lack of power for the BNM to access auditors' working papers. In practice however the BNM has not yet used this power for conventional banks.
- Where the law provides for certain decisions to be referred to the MOF, BAFIA explicitly provides that decisions by the MOF should be made upon the recommendations of BNM. This is currently not explicitly available under the IBA.

Further enhancements are envisaged under the FSA to streamline legal and regulatory requirements and powers of BNM in regulating the Islamic financial sector alongside the conventional financial sector. Major parts of the IFSA, for instance licensing, regulation and supervision of financial groups and examination powers, contain mirror provisions to the FSA to ensure consistency of rules and regulation across both sectors and eliminate potential regulatory arbitrage (about 75% of the provisions in IFSA are the same as in the FSA). In addition, the proposed new legislation seeks to provide greater visibility to Shariah compliance and the effective implementation of Shariah governance by Islamic financial institutions, thus ensuring a coherent regulatory framework. Among others, proposed provisions have been put forward to allow BNM to specify standards on Shariah matters, including rules relating to Shariah governance, principles and practices of Shariah in relation to the business and affairs of an Islamic institution, as well as requirements for Shariah compliance audits. In line with Shariah requirements, the proposed new law will also clarify the nature of Shariah contracts employed in conducting Islamic banking business and the process and priority of payments in the event of a winding up of a financial institution involved in Islamic financial business.

## D. Main Findings

### *Objectives, Independence Powers, Transparency, and Cooperation (CP 1)*

12. **The role of BNM and other authorities is clearly defined in law.** The statutory responsibilities and objectives of BNM are stated in the CBA and BAFIA, supported by internal governance arrangements. The adoption of the new Policy Framework will increase the transparency in policy activities. Governance arrangements (including operational procedures) and the roles/responsibilities of various functions within the BNM have yet to be more explicitly defined. The BNM is well funded and its staff has credibility based on their professionalism and integrity.

13. **The assessors found some instances in the legal framework where the Minister could interfere with BNM's independence.** In practice, however, the assessors have not come across evidence of de facto government or industry interference. It would provide greater legal certainty regarding the independence of the BNM if these provisions were removed and the independence of the BNM were formally grounded in the law.

14. **Legal protection for bank supervisors is in place and as a matter of practice the employees costs of defending actions made while discharging their duties in good faith would be borne by the BNM.** But some enhancements could be made. Ideally, the CBA should specifically state that the legal protection provided to the BNM employees is not limited in time (i.e. provides protection beyond the termination of appointment or employment). Also, at the minimum, it is necessary that protection against incurring the costs of defending the actions of supervisors is stated clearly and explicitly (at least at the level of internal procedures).

15. **BNM has a good framework for information sharing with foreign supervisors, but domestic information sharing arrangements could be improved.** The MOU with the SC should be expanded to cover more than the investment banks that the SC and BNM co-regulate.<sup>3</sup> Information sharing with the SKM could also be formalized. Finally, the BNM should consider entering into MOUs with countries of major new entrants (e.g., Japan).

### *CP 2-5 Licensing and structure*

16. **The Malaysian banking law appropriately defines and controls the business of banking, with Bank Negara strongly overseeing the evolution of the banking structure, with some areas of needed concurrence (e.g., license approval) from the Minister of Finance.** BNM has presented publicly long term plans for banking and financial structure that have guided ongoing decision-making—as the country responded to the Asian banking crisis of the 1990s by consolidating banks into the current eight large banking groups that

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<sup>3</sup> The October 2012 update to the BNM-SC MoU addresses these issues.

dominate the domestic market. Since that consolidation, the structure has been kept relatively stable with no new licenses for conventional commercial banks granted from 1970 until 2009; consistent with the long run plan to encourage the development of the Islamic banking sector, a number of Islamic bank licenses have been granted since 2004. There has been little public transparency on the criteria used in BNM's review of licensing and acquisitions that have occurred in recent years, as BNM has chosen to share expectations only directly with the applicants. Enhancing transparency and ensuring that appropriate focus is given to shareholders of banks in addition to the applicant banks are areas where improvements can be made.

***Prudential Regulation and Requirements (CPs 6-18)***

17. **The BNM has set prudent and appropriate minimum capital adequacy requirements but the scope of application of capital requirements should be widened to include the FHC.** Banks are well capitalized with strong system-wide risk-weighted capital ratio and core capital ratios. The BNM has accredited ten banks to adopt the Basel II foundation IRB approach for credit risk and two banks to adopt the standardized approach for operational risk. The BNM does not have the power to include the FHC in the scope of application of capital adequacy requirements (the new FSA should remedy this gap). Basel III implementation is planned in accordance with the international timetable.

18. **BNM issued comprehensive guidelines specifying the requirements and regulatory expectations for banking institutions to have in place an effective system for management of problematic assets and processes to ensure the adequacy of provisions and reserves.** In the event that BNM has supervisory concerns over banking institution's asset quality and adequacy of provisions, BNM has the power to require banks to increase the level of provisions and reserves as well as banking institutions' financial strength via higher minimum capital requirements. The regulations as well as the supervisory framework cover the overall credit risk process in terms of identification, management and mitigation.

19. **The assessors identified several other areas for strengthening of prudential regulation.** More detailed regulation and supervisory expectations in the area of interest rate risk in the banking book, credit concentrations, operational risk and country risk are recommended. Also, the BNM should formally require banks to have a separate and independent risk management unit. The BNM has recently released prudential regulations covering Pillar 2 and many banks are making good progress towards their implementation. That said, full implementation is required to further strengthen oversight of interest rate risk in the banking book and credit concentrations.

***Methods of Ongoing Banking Supervision (BCP 19-21)***

20. **BNM supervises the activities of banks with a well-structured risk focused supervisory approach that integrates well on-site supervisory practices, extensive**

**regulatory reporting, and off-site monitoring.** BNM's Supervisory Risk-based Framework provides a strong structure for supervisors to carry out consistent and effective supervision, both through individual firm supervision and through horizontal or thematic reviews. Decision-making within this structure, as to onsite reviews to be conducted and special off-site surveillance work, is carried out by teams of supervisors headed by a Relationship Manager (RM). The supervision work carried out by the RM and his/her team is supported by micro-surveillance personnel, a macro-surveillance unit and a Specialized Risk Unit (SRU). A careful system of checks and balances has been implemented, involving vetting of ratings and other supervisory products through at least one, and sometimes two, layers of independent panels within the Supervision Department. Ratings and supervisory recommendations and remediation requirements are conveyed effectively to banking institutions in writing, and through extensive interaction with the Board and senior management; necessary remediation is followed through in a highly disciplined way.

21. **Emerging global practices are being introduced and BNM has incorporated increasingly sophisticated supervisory techniques and expectations into its risk focused approach.** There are challenges in ensuring that appropriately specialized supervisory expertise is maintained, and utilized to maximum effect. BNM is moving forward to incorporate Basel II, Pillar 2 and ICAAP expectations, and will soon be looking to address recovery and resolution planning. BNM currently has relatively few specialists in the SRU, and the bulk of those experts' time is spent in-house, providing guidance to the general supervisors. As BNM has found with model validation requirements, specialized risk people can provide major contributions on-site. Over time, the assessors expect that the cadre of specialized people should be expanded, and more of their time spent in direct interaction with bankers.

*Accounting and disclosure (CP 22)*

22. **The BNM has adequate regulations in place in the area of accounting and disclosure by banking institutions.** The BNM approves the external auditors for banks on an annual basis and maintains an ongoing dialogue with them during the course of the audit cycle. Feedback from market participants reflected a need for clearer communication of auditors' supervisory expectations to banks. Hence, assessors recommend the BNM more clearly communicate to banks its supervisory expectations, particularly in case additional procedures, may be required on top of the normal audit procedures.

*Corrective and Remedial Powers (CP 23)*

23. **BNM has broad discretion in the range of remedial actions it can take to address problem situations, which it takes within a well designed early intervention program.** BNM's Supervisory Intervention Guide sets out a clear set of steps to take if a bank's condition deteriorates and its risk increases, with BNM having the clear power to issue directives to banks to take appropriate remediation actions.

24. **A new Strategic Alliance between BNM and PIDM was agreed while the BCP review was taking place, and its effectiveness should be reviewed over time.** Among the issues to address is how the assessment of the viability of an institution is to be made (and how transparent the criteria should be) and how the resolution framework could be applied to financial holding companies.

*Consolidated and Cross-border Banking Supervision (CP 24-25)*

25. **A clear gap exists in BNM's legislative authority for the supervision and regulation of FHCs.** The BNM has been effective in narrowing (but not eliminating) the gap, and the proposed new FSA would address the statutory shortcoming. Six of the eight large domestic banking groups have parent FHCs, and the current legislative framework does not by its terms apply to those firms on a parent only or consolidated basis. Many of the affiliates of the bank are regulated by the BNM, but some (such as asset managers) are not. The BNM has been creative by imposing conditions on the FHCs incident to approval of their investments in their banks, covering the nomination of their directors and CEO, acquisitions of shares of other companies, the issuance of capital instruments, and more generally complying with BNM guidelines. BNM has also used legislative authorities applicable to affiliates of banks to apply reporting and examination requirements to the FHC and its subsidiaries. Through these means, the BNM has been able to significantly reduce the existing gap, but not to completely eliminate it. No consolidated capital ratios apply to the FHCs; the liquidity framework does not apply on a consolidated basis; and no stress testing expectations are applied on a consolidated basis. The proposed legislative change, if enacted, would address many of these issues.

26. **BNM has a very well developed program of information exchange and supervisory cooperation with an appropriate set of foreign supervisors, although it could make some elements of information exchange globally and domestically more formal.** BNM has put in place an extensive set of MOUs and less formal information exchange mechanisms with a relevant set of international supervisors. In addition it has been active in hosting and participating in supervisory colleges and carrying out its own program of overseas examinations. It has also been in the forefront in offering training programs to other supervisors in the region. As a matter of good practice going forward, BNM should, in licensing foreign banks subsidiaries, do a formal independent assessment of consolidated home country supervision and look to enter into MOUs with countries of the major new entrants. BNM's MOU with the SC should be modified to make it much more directed to consolidated supervision, and an MOU with the Cooperatives Commission should be negotiated.

**Table 1. Summary Compliance with the Basel Core Principles—Detailed Assessments**

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	<p>Laws are in place for banking and the role of BNM is clearly defined. Clear responsibilities and objectives for other authorities are also in place. The BNM has issued the “Financial Sector Blueprint 2011-2020”, a strategic plan that lays out the future direction of the Malaysian financial system.</p> <p>The assessors recommend the BNM uses stronger language in its guidelines and recommendations, clearly stating that banks “must” observe the regulatory requirements instead of “shall” observe the regulatory requirements. This will be addressed by the BNM’s Policy Development Framework which was rolled out for implementation on 17 May 2012.</p>
1.2 Independence, accountability and transparency	<ul style="list-style-type: none"> <li>• Transparency in the policy activities of the BNM could be increased. This will be achieved by the adoption of the new Policy Framework.</li> <li>• Governance arrangements (including operational procedures) and the roles/responsibilities of various functions within the BNM have yet to be disclosed to the public for clarity and accountability.</li> </ul> <p>There are some instances in legal framework where the Minister could interfere with BNM’s independence. For example, Section 70 in BAFIA allows the Minister at any time to direct the Bank to make an examination of the books or other documents, accounts and transactions of any licensed institution if he has certain suspicions with regard to a banking institution. Also, Section 15 of BAFIA allows companies to use the word “bank”, “banking” (...) or any derivatives of this word with the explicit approval of the Minister. Furthermore, Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, with the concurrence of the Minister remove and/or appoint new officers and directors; the BNM can also recommend to the Minister the revocation of a banking license and approval of transfer of significant ownership.</p> <p>In practice, however, the assessors have not come across evidence of Government interference which would seriously compromise the independence of the BNM. It would provide greater certainty regarding the independence of the BNM if these provisions were removed and the independence of the BNM were formally grounded in the law.</p>
1.3 Legal framework	<ul style="list-style-type: none"> <li>• The BNM will further enhance transparency by wider public consultation on proposed policy measures in accordance with the Policy Development Framework.</li> <li>• For the sake of transparency, the BNM should align the terminology used in its regulations. Circulars, guidelines and best practices are generally considered binding for banks and there may not be any need to distinguish between them.</li> </ul>
1.4 Legal powers	BNM has the authority to address compliance with laws and safety and soundness concerns through a broad grant of legislative authority.

Core Principle	Comments
1.5 Legal protection	<p>Staff and persons appointed by the BNM are covered by the statutory immunity clause for any action taken in good faith in pursuance of their duties.</p> <p>The assumption of the legal cost for defending against lawsuits faced by individual supervisor could be anchored in the law.</p> <p>The legal coverage should not depend on the person's employment status at the time of the lawsuit; former employees should be explicitly included. Further, consideration should be given to include a provision permitting the BNM to indemnify these persons for their legal costs in the event they are sued.</p>
1.6 Cooperation	<p>BNM has a good framework for information sharing with foreign supervisors, but information sharing arrangements could be improved through:</p> <ul style="list-style-type: none"> <li>• expanding the MOU with the SC to cover more than the investment banks that the SC and BNM co-regulate (i.e. to include asset management companies), and provide for the SC to share information with BNM and for BNM to alert the SC of supervisory developments in the broader banking group that could affect those institutions within the group regulated by the SC.</li> <li>• more formalized information sharing with the SKM.</li> <li>• the BNM entering into MOUs with countries (e.g., Japan) of major new entrants.</li> </ul>
2. Permissible activities	<p>The existing legal and regulatory provisions appropriately define and control the business of banking, including, in particular, deposit-taking. There are some deposit-taking companies not regulated by BNM.</p>
3. Licensing criteria	<p>BNM has a conservative program for the granting of new licenses, where in the exception of the explicit inviting of companies to apply for a stipulated set of new licenses (as occurred in 2009), no applications for conventional commercial banks have been considered in forty years. New legislation (FSA) would, at such time as it is enacted, deal with many of the limitations in the current approach, listed below, but in any event, going forward BNM should address the following:</p> <ul style="list-style-type: none"> <li>• Reflecting the infrequency with which applications have been entertained, the degree of transparency in the criteria to be applied has been less than in other countries and should be improved.</li> <li>• The focus of the application review was most heavily on the immediate applicant, although some review is done of ultimate shareholders. The criteria should explicitly include an assessment on the nature and sufficiency of financial resources and the integrity of the shareholder.</li> <li>• In the case of foreign banks, there is no explicit independent evaluation of the nature and degree of consolidated regulation and supervision applied by the home country supervisor, as review is focused essentially on available FSAPs.</li> <li>• Criteria on the suitability of officers (covering more of the senior team than the CEO) and the achievability of business plans need to be more explicit;</li> </ul>
4. Transfer of significant ownership	<p>The framework for controlling the ownership of banks is a good one, but should be refined:</p> <ul style="list-style-type: none"> <li>• BNM must have the capacity to address directly unauthorized acquisitions of shares, or control, of a banking institution, such</li> </ul>

Core Principle	Comments
	<p>as requiring divestitures and/or cessation of control.</p> <ul style="list-style-type: none"> <li>• BNM should have an ability to learn about and deal with changes in the suitability of major shareholders.</li> </ul>
5. Major acquisitions	<p>Overall approach is effective but there are some improvement opportunities:</p> <ul style="list-style-type: none"> <li>• BNM should look to codify criteria more explicitly for major acquisitions.</li> <li>• BNM needs more explicit authority to take corrective action against non-banking companies that could be acquired if they subsequently prove to be detrimental to the interests of the bank affiliate.</li> </ul>
6. Capital adequacy	<p>Banks remain well capitalized with system-wide risk-weighted capital ratio and core capital ratios at 14.9 percent and 12.9 percent respectively in 2011.</p> <p>The scope of application of the capital framework should be widened to include financial holding companies, as outlined in the Basel II scope of application.</p> <p>Some other, but minor, amendments to fully align the capital framework with the BCBS standards should also be made. The assessors, however believe the impact not to be material, particularly in view of the other areas where the BNM is stricter than the Basel minimum.</p> <p>Basel II consists of three mutually reinforcing pillars; the BNM should therefore also fully implement Pillar 2 as soon as possible. Having a Pillar 1 and Pillar 3 in place without a fully fledged Pillar 2 process is, strictly speaking, not in line with the sound Basel II implementation.</p> <p>Moving forward, BNM will have enhanced legal powers under the new financial services legislation to enable the application of capital framework on financial holding companies and is in the process of fully aligning the definition of capital with the implementation of Basel III in Malaysia.</p>
7. Risk management process	<p>BNM has a good framework for risk management, but there are some improvement opportunities:</p> <ul style="list-style-type: none"> <li>• Increase the number and experience level of risk specialists and ensure they spend more time in the field (currently, other than model validation reviews, such specialists only occasionally do on-site reviews);</li> <li>• Ensure that under the current law that prudential risk management policies are explicitly and consistently applied to consolidated FHCs;</li> <li>• Ensure in particular that relevant stress tests are applied to consolidated FHCs.</li> <li>• BNM needs to issue a guideline that specifically requires banks to have a dedicated unit responsible for the risk management process.</li> </ul>
8. Credit risk	<p>The regulations as well as the supervisory framework cover the overall credit risk process in terms of identification, management and mitigation.</p>
9. Problem assets, provisions, and reserves	<p>BNM is in compliant with Principle 9. BNM issued comprehensive guidelines specifying the requirements and regulatory expectations for banking institutions to have in place an effective system for management of problematic assets and processes to ensure the adequacy of provisions and reserves.</p> <p>In the event that BNM has supervisory concerns over banking institution's asset quality and adequacy of provisions, BNM has the power to require</p>

Core Principle	Comments
	banks to increase the level of provisions and reserves as well as banking institutions financial strength via higher minimum capital requirements.
10. Large exposure limits	<p>Generally speaking, laws, guidelines and supervisory practices are in place to ensure banking institutions' large exposures are prudently managed.</p> <p>Some enhancements can be made in the following areas:</p> <ul style="list-style-type: none"> <li>• a more comprehensive definition of "a group of connected counterparties" including the notion of economic dependency;</li> <li>• a more active use of Pillar 2 to identify and assess credit concentrations; and</li> <li>• the alignment of the large exposure limits with international best practice</li> </ul> <p>The BNM is planning to issue a revised guideline for credit concentrations: The revised guideline is expected to comprehensively address all the requirements of Principle 10. Specifically, the enhancements to the guidelines include:</p> <ul style="list-style-type: none"> <li>• Clear and specific risk management expectations on compliance with the prudential limits; and</li> <li>• Comprehensive guidance on determining interconnectedness of counterparties;</li> <li>• Review of prudential limits; and</li> <li>• Guidance on measurement of exposures to properly reflect exposures and ensure consistency.</li> </ul>
11. Exposure to related parties	While the overall approach to connected lending is generally sound, the exclusion of some significant minority shareholders is a gap that should be addressed.
12. Country and transfer risks	<p>Although the assessors are broadly satisfied that country risk is identified and assessed on a timely basis as part of the supervisory framework, there is a need for more explicit legal and regulatory requirements on banks in the area of country and transfer risk. With the growing internationalization of the Malaysian banking system, the BNM should expect that country and transfer risk be managed as a separate risk category.</p> <p>The BNM is to be commended for its periodic internal reporting on country risk.</p>
13. Market risks	<p>The regulatory guidelines are comprehensive and clear with regard to the trading book.</p> <p>The assessors recommend more market risk specialists are trained in market risk.</p> <p>The assessors recommend the risk specialist accompany the supervisor on onsite examinations for higher risk institutions.</p>
14. Liquidity risk	<p>The regime for bank liquidity risk management is a sound one, but improvements could be made in the application of the regime to FHCs.</p> <ul style="list-style-type: none"> <li>• BNM supervisors need to conduct ongoing reviews of FHC consolidated liquidity</li> <li>• BNM needs to require that an FHC conducts a consolidated liquidity stress test and table the stress test results at ALCO.</li> </ul>
15. Operational risk	<p>Although high level operational risk management requirements are generally in place and adhered to, the assessors recommend</p> <ul style="list-style-type: none"> <li>• the release of more detailed regulation</li> <li>• the training of more supervisors in the operational risk specialist risk stream</li> <li>• operational risk specialists attend on site examinations for higher risk</li> </ul>

Core Principle	Comments
	<p>institutions.</p> <p>BNM is currently developing an Operational Risk Reporting System to upgrade eFIDS into a full-fledged operational risk event and loss reporting system, for increased surveillance capability as well as for information sharing with the industry. This will include revision to the fraud taxonomy to cater for fraud events that are inherent in investment banking activities. The system is expected to be operational in the first quarter of 2013. The BNM is already addressing the first recommendation by drafting the Operational Risk Management Guidelines. The guidelines will also mandate the reporting of all operational risk loss events.</p>
16. Interest rate risk in the banking book	<p>The assessors reviewed the assessment of IRRBB as part of their review of a number of supervisory files and were satisfied with the depth and scope of the individual institutions' and horizontal reviews. That said:</p> <ul style="list-style-type: none"> <li>• There is currently no regulation addressing IRRBB; and <ul style="list-style-type: none"> <li>• Feedback from banks indicated this is an area where supervisory expectations need to be clarified; and</li> <li>• More specialists need to be trained in IRRBB and they should attend the onsite inspections for higher risk institutions.</li> </ul> </li> </ul>
17. Internal control and audit	<p>BNM has a strong program for ensuring that effective governance, staffing, and processes are in place for the important control functions of a bank. The BNM focuses heavily and effectively on offering director training programs.</p>
18. Abuse of financial services	<p>The assessors recommend AML/CFT Specialists join onsite BNM supervisors for the examination of higher risk banks.</p>
19. Supervisory approach	<p>BNM has a well developed framework of supervision with a strong mechanism to ensure effective and consistent analysis of risks, with access to a variety of information sources to keep its assessments current. We have several recommendations for improvement:</p> <ul style="list-style-type: none"> <li>• Increase the number and experience level of risk specialists and provide for their spending more time in the field;</li> <li>• Revisit its methodology for assigning ratings to banks to provide capacity to factor in more explicitly adverse effects from affiliates.</li> </ul>
20. Supervisory techniques	<p>BNM has a strong and well structured supervisory program, using appropriate supervisory techniques.</p>
21. Supervisory reporting	<p>The assessors recommend BNM require at least annual physical sign off of the prudential returns by the Senior Management of the bank. The BNM is currently enhancing its on-line statistical reporting (i.e. the Integrated Statistical System (ISS) Project) to incorporate a digital signatory requirement by senior management for each submission by the banks.</p> <p>While the assessors commend the BNM for the legal provisions with regard to the power of the BNM to require adjustments to the financial statements and to obtain supporting evidence, they recommend BNM discontinue the use of Section 41 (4) of Bafia. This specific article requires the BNM to inform the banking institution in writing that the financial statements and supporting documents are satisfactory in terms of form and content. This requirement somehow interferes with the independence and responsibility of the external auditor and unduly exposes the BNM to reputational risk.</p>
22. Accounting and disclosure	<p>Feedback from market participants reflected a need for clearer communication of auditors' supervisory expectations to banks. Hence, assessors recommend the BNM more clearly communicate to banks its supervisory expectations in case additional procedures may be required on top of the normal audit procedures.</p>

Core Principle	Comments
23. Corrective and remedial powers of supervisors	<ul style="list-style-type: none"> <li>• Look to strengthen the legislative basis for the determination of non-viability it is required to make for troubled banks.</li> <li>• Determine the resolution approach for FHCs.</li> <li>• Revise its MOU with the SC to strengthen the requirement on BNM to notify the SC of actions being applied to the bank affiliate of an investment bank or asset management company; the MOU is in the process of being enhanced to provide for greater coordination and cooperation between BNM and SC, and to provide for examinations by BNM of entities within the financial group which are licensed by the SC.</li> <li>• Expand the penalties that can be imposed on individuals under Civil Law.</li> </ul>
24. Consolidated supervision	<p>BNM has been creative and largely effective in putting in place and implementing a consolidated supervisory framework despite obvious shortcomings in the enabling legislation as it applies to FHCs. BNM recognizes the need to address the legislative shortcomings, which would be extremely helpful, although some specific supervisory changes are also recommended.</p> <ul style="list-style-type: none"> <li>• Needs to move quickly to put in place explicit legislative authorities for oversight and supervision of FHCs.</li> <li>• Whether under the current or new legislation, formalize the application of prudential regulatory provisions to the consolidated organization.</li> <li>• Needs to strengthen its guidance for the assessment of parent companies.</li> <li>• The MOU with the SC should be broadened to provide for SC sharing with BNM of information on asset management companies and other affiliates of a bank.</li> <li>• BNM should have the authority to require the closing of foreign offices or to impose conditions on their activities.</li> </ul>
25. Home-host relationships	<p>BNM has a very well developed program of information exchange and supervisory cooperation with an appropriate set of foreign supervisors. BNM has been in the forefront in offering training programs to other supervisors in the region. Some recommendations for improvements;</p> <ul style="list-style-type: none"> <li>• In licensing foreign banks subsidiaries, BNM should do a formal independent assessment of consolidated home country supervision.</li> <li>• BNM should enter into MOUs with countries that have major new entrants.</li> </ul>

## E. Key Findings and Recommended Action Plan

**Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles**

Reference Principle	Recommended Action
<b>Objectives, Independence, Powers, Transparency and Cooperation (CP 1)</b>	<ul style="list-style-type: none"> <li>• Remaining provisions in law requiring consultation with the Minister for supervisory actions should be removed and the independence of the BNM formally grounded in the law.</li> <li>• Expand the MOU with the SC to: cover more than the investment banks that the SC and BNM co-regulate (i.e., to include asset management companies and unit trusts which can also be part of banking groups); provide for SC to share information with BNM on entities it supervises within FHCs; and provide for BNM alerting the SC to supervisory developments in the broader banking group that could affect those institutions within the group regulated by the SC</li> <li>• Enter into more formalized information sharing arrangements with the SKM;</li> <li>• Enter into MOUs with countries (e.g., Japan) of major new entrants.</li> <li>• Expand legal coverage so that former employees are explicitly included. Consider including a provision permitting the BNM to indemnify these persons for their legal costs in the event they are sued.</li> </ul>
<b>Licensing Criteria (CP3)</b>	<ul style="list-style-type: none"> <li>• Reflecting the infrequency with which applications have been entertained, the degree of transparency in the criteria to be applied has been less than in other countries and should be improved.</li> <li>• The focus of the application review was most heavily on the immediate applicant, although some review is done of ultimate shareholders. The criteria should explicitly include an assessment on the nature and sufficiency of financial resources and the integrity of the shareholder.</li> <li>• In the case of foreign banks, there is no explicit independent evaluation of the nature and degree of consolidated regulation and supervision applied by the home country supervisor, as review is focused essentially on available FSAPs.</li> <li>• Criteria on the suitability of officers (covering more of the senior team than the CEO) and the achievability of business plans need to be more explicit; (the draft FSA, if enacted, will require the latter)</li> </ul>
<b>Transfer of Significant Ownership (CP4)</b>	<ul style="list-style-type: none"> <li>• BNM must have the capacity to address directly unauthorized acquisitions of shares, or control, of a banking institution, such as requiring divestitures and/or cessation of control.</li> <li>• BNM should have an ability to learn about and deal with changes in the suitability of major shareholders.</li> </ul>
<b>Major Acquisitions (CP 5)</b>	<ul style="list-style-type: none"> <li>• BNM should codify criteria for major acquisitions;</li> <li>• BNM needs more explicit authority to take corrective action against non-banking companies that could be acquired if they subsequently prove to be detrimental to the interests of the bank affiliate.</li> </ul>
<b>Capital adequacy (CP6)</b>	<ul style="list-style-type: none"> <li>• Expand the scope of application of the capital framework to include financial holding companies, as outlined in the Basel II scope of application.</li> <li>• Make amendments to fully align the capital framework with the BCBS standards.</li> <li>• Fully implement Pillar 2.</li> </ul>

<b>Risk Management Process (CP 7)</b>	<ul style="list-style-type: none"> <li>• Increase the number and experience level of risk specialists and ensure they spend more time in the field, performing on-site review particularly at large and complex banks;</li> <li>• Ensure that prudential risk management policies are explicitly and consistently applied to consolidated FHCs, as is provided for under the draft FSA;</li> </ul>
<b>Risk Management Process (CP 7)</b>	<ul style="list-style-type: none"> <li>• Ensure in particular that relevant stress tests are applied to consolidated FHCs.</li> <li>• BNY needs to issue guidance on the requirement for firms to have separate risk management units.</li> </ul>
<b>Large Exposures (CP10)</b>	<ul style="list-style-type: none"> <li>• Fully use Pillar 2 to identify and assess credit concentrations;</li> </ul>
<b>Related Parties (CP 11)</b>	<ul style="list-style-type: none"> <li>• Reassess the change made to the definition of connected parties in 2008, excluding significant (20%-50%) shareholders (unless they had a director) and their subsidiaries and associated companies, from the definition</li> </ul>
<b>Country Risks (CP 12)</b>	<ul style="list-style-type: none"> <li>• Introduce more explicit legal and regulatory requirements on banks in the area of country and transfer risk.</li> </ul>
<b>Market Risk (CP 13)</b>	<ul style="list-style-type: none"> <li>• Strengthen the supervisory framework by letting market risk specialist participate in on site exams for higher risk institutions</li> </ul>
<b>Liquidity Risk (CP 14)</b>	<ul style="list-style-type: none"> <li>• BNM supervisors need to conduct ongoing reviews of FHC consolidated liquidity</li> <li>• BNM needs to require that an FHC conducts a consolidated liquidity stress test and table the stress test results at ALCO.</li> </ul>
<b>Operational Risk (CP 15)</b>	<ul style="list-style-type: none"> <li>• Release more detailed regulation and supervisory expectations in the area of operational risk.</li> <li>• Train more specialists in operational risks specialist risk stream let them accompany supervisors on onsite examinations, particularly for higher risk institutions.</li> </ul>
<b>Interest Rate Risk in the Banking Book (CP 16)</b>	<ul style="list-style-type: none"> <li>• Release more detailed regulation and supervisory expectations in the area of interest rate risk in the banking book.</li> <li>• Implement Pillar 2 fully.</li> </ul>
<b>Abuse of Financial Services (CP 18)</b>	<ul style="list-style-type: none"> <li>• Let AML/CFT specialists accompany supervisors during on site examinations, particularly for high risk institutions.</li> </ul>
<b>Supervisory Approach (CP 19)</b>	<ul style="list-style-type: none"> <li>• Increase the number and experience level of risk specialists and provide for their spending more time in the field;</li> <li>• Revisit methodology for assigning ratings to banks to provide capacity to factor in more explicitly adverse effects from affiliates</li> </ul>
<b>Supervisory Reporting (CP 21)</b>	<ul style="list-style-type: none"> <li>• Require at least annual physical sign off of the prudential returns by the Senior Management of the bank. The BNM is currently enhancing its on-line statistical reporting (i.e. the Integrated Statistical System (ISS) Project) to incorporate a digital signatory requirement by senior management for each submission by the banks.</li> <li>• Discontinue the use of Section 41 (4) of BAFIA. This specific article requires the BNM to inform the banking institution in writing that the financial statements and supporting documents are satisfactory in terms of form and content. This requirement somehow interferes with the independence and responsibility of the external auditor and unduly exposes the BNM to reputational risk. (This provision is sought to be removed in the proposed FSA).</li> </ul>

<b>Accounting/Disclosure (CP 22)</b>	<ul style="list-style-type: none"> <li>• Ensure clear communication to banks in case additional external audit procedures are required.</li> </ul>
<b>Supervisors' Corrective and Remedial Powers (CP 23)</b>	<ul style="list-style-type: none"> <li>• Look to strengthen the legislative basis for the determination of non-viability it is required to make for troubled banks.</li> <li>• Determine the resolution approach for FHCs.</li> <li>• Revise its MOU with the SC to strengthen the requirement on BNM to notify the SC of actions being applied to the bank affiliate of an investment bank or asset management company.</li> <li>• Expand the penalties that can be imposed on individuals under Civil Law.</li> </ul>
<b>Consolidated Supervision (CP 24)</b>	<ul style="list-style-type: none"> <li>• Put in place explicit legislative authorities for oversight and supervision of FHCs.</li> <li>• Whether under the current or new legislation, formalize the application of prudential regulatory provisions to the consolidated organization.</li> <li>• Strengthen the guidance for the assessment of parent companies.</li> <li>• The MOU with the SC should be broadened to provide for SC sharing with BNM of information on asset management companies and other affiliates of a bank.</li> <li>• BNM should have the authority to require the closing of foreign offices or to impose conditions on their activities.</li> </ul>
<b>Home-Host relationships (CP 25)</b>	<ul style="list-style-type: none"> <li>• In licensing foreign bank subsidiaries, BNM should do a formal independent assessment of consolidated home country supervision</li> <li>• BNM should enter into MOUs with countries (e.g., Japan) with major new entrants.</li> </ul>

## F. Authorities' Response to the Assessment

27. **The Malaysian authorities wish to express their appreciation to the assessment team for their comprehensive work and high degree of professionalism in conducting the assessment.** We value the candour in the interactions we had with the members of the assessment team which enabled us to exchange ideas and insights as the Bank continues ongoing efforts to further strengthen the supervisory and regulatory regime for the Malaysian banking sector.

28. **The assessment concludes that the Malaysian banking sector is supervised under a well developed risk-focused and comprehensive regime.** The areas of recommendation largely correspond with the Bank's current priorities to further strengthen the regulatory and supervisory system, and validate the various initiatives that are at advanced stages of implementation or for which definite plans have been put in place. These measures will place the Malaysian banking sector on a stronger footing as they expand in scope and geographic reach.

29. **A significant number of the recommendations will be addressed by the proposed financial services legislation.** Amongst others, this will provide greater clarity in licensing standards, suitability requirements for shareholders, powers to address unauthorized

acquisition of shares, powers for enforcement of corrective actions, and the regulation and supervision of financial holding companies. A number of regulatory standards are currently being revised to enhance the framework on risk management, large exposures and corporate governance, and the issuance of the Risk Governance guidelines in the second half of 2012 will set explicit expectations on the need for a dedicated risk management unit within banks. With regard to Basel II implementation, the supervisory expectations for Pillar 2 is already in place and beginning 2013, the full supervisory review and examination process will be conducted on all banks. The report mentions in several places that additional supervisory resources, especially in the specialist risk areas, are likely to be required to continue to deliver on and to augment supervisory practices. This is being addressed as part of the organizational development initiative and the participation of specialist risk units in the on-site examination exercises will be intensified moving forward. On the comment regarding legal protection for past employees, the legal provision applies to both current and former employees of the Bank, as long as the suit against him is in respect of an act committed or statement made by him in his capacity as an employee of the Bank, and in good faith. As such, it is not necessary to expressly distinguish former employees in the legislation.

30. **In line with increasing regional and international financial integration, a Home-Host Supervisory Cooperation framework has been put in place to affirm existing arrangements with foreign supervisors to ensure effective sharing and flow of information.** Domestically, the Strategic Alliance Agreement with the Malaysia Deposit Insurance Corporation has since been revised to specify the triggers for non-viability and the Memorandum of Understanding with the Securities Commission is being enhanced to provide for clear arrangements with respect to the assessment of entities within a financial group. The current practice of having bilateral and trilateral engagement with external auditors will also be better documented and shared to set clear the expectations placed on the external auditors.

31. **For BCPs that were assessed as compliant, we will seek continuous improvements particularly in light of the revised BCP that will be introduced in the near future.**

## II. ASSESSMENT OF INSURANCE CORE PRINCIPLES (ICPs)<sup>4</sup>

### A. Summary, Key Findings, and Recommendations

32. **Bank Negara Malaysia (BNM) is a highly respected insurance regulator: the regulatory guidance is comprehensive, and the supervision is effective and well-focused.** BNM has the capacity and is taking proactive steps to address shortcomings in the insurance regulatory framework to achieve full observance of the ICPs. The proposed financial institutions legislation<sup>5</sup> should address concerns with BNM's powers for group-wide supervision and ensure that client monies with intermediaries are properly protected. The implementation of the Internal Capital Adequacy Assessment Process (ICAAP), and new risk governance guidance, will close current gaps in BNM's formal expectations for better risk management practices by insurers. Lastly BNM is not a home supervisor to any insurance group, and cross-border activities of Malaysian insurers are not significant, so there may not currently be a significant urgency for BNM to implement substantive measures to ensure it can be effective in cross-border coordination during a crisis. Given the speed of change in the financial sector, including the insurance industry, BNM should endeavor to seek continuous improvements in its supervisory practices as well.

33. **The assessment did not reveal any current potential sources of significant risk to Malaysian financial stability from its insurance industry.** The sector continues to be relatively small and fragmented, without any major risk accumulations that could pose stability concerns. Insurers should continue to be monitored to ensure they do not introduce imprudent practices and instability within the industry, with special attention paid to those that may not have an extensive track record of conducting business in Malaysia, such as new entrants and insurers where there has been a recent change of control. Also, any substantial growth in risk accumulations in Danajamin should be very closely monitored, given the nature of its business risks and the incomplete regulatory framework that exists for financial guarantee insurance. BNM has indicated that efforts will be taken to strengthen the regulatory framework for financial guarantee insurance.

### B. Introduction and Scope

34. **This assessment provides an understanding of the significant regulatory and supervisory framework for the insurance sector of Malaysia.** The market has been growing for Islamic insurance products (family takaful, general takaful, and re-takaful). The ICPs were not specifically developed with Islamic insurance products in mind. Consequently, based on the agreed scope, details on the regulation, supervision and various workings of

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<sup>4</sup> The assessment was conducted by Mark Causevic (IMF Consultant; OSFI, Canada).

<sup>5</sup> The FSA bill was passed in December 2012.

Malaysian Islamic insurance market are included in this report, but do not form part of the ICP assessment ratings for Malaysia.

35. **The assessment is based solely on the laws, regulations and other supervisory requirements and practices that are in place at the time of the assessment.** Ongoing regulatory initiatives are noted by way of additional comments e.g., proposed legislation.

### C. Overview: Institutional and Macro Prudential Setting

#### *Market Structure and Industry Performance*

36. **While the market is fairly sophisticated, offering a wide range of life, non-life and takaful insurance products, there is scope for further growth and consolidation.** Current industry challenges that BNM has identified and is addressing include asset-liability matching in a low interest rate environment, rising claims costs and increased volatility in the global markets.

37. **Access to and foreign ownership of the Malaysian insurance market is restricted.** No direct conventional insurance license has been issued since the 1970s. New reinsurance, takaful and retakaful licenses have been issued from time to time since 1995 to meet specific objectives to enhance domestic reinsurance capacity and further develop the takaful industry. The foreign equity limit for insurers is 70 percent. A foreign equity limit above 70 percent will be considered on a case-by-case basis, particularly for players that can facilitate consolidation and rationalization of the general insurance industry.

38. **Four out of nine life insurers are owned by the large domestic banks and domestic parties account for most of the ownership of the Malaysian general insurers.** Nevertheless, foreign-owned insurers have a major presence in Malaysia, with foreign-owned insurers ranking as or amongst the largest insurers in the life and non-life sectors. Domestic banks have major presence in the takaful market, with the dominant takaful operator being a subsidiary of a large domestic bank.

39. **The cross-border operations of domestic insurers remained very small in terms of size and span.** In 2011, such operations involved total assets of RM979.8 million, amounting to only 0.5 percent of total insurance industry assets, spanning four countries near the Malaysian borders (Figure 1).

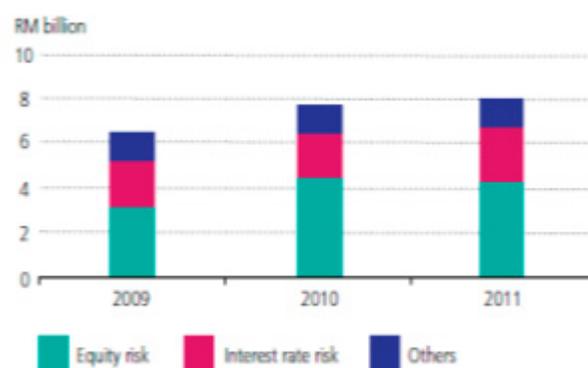
40. **Agency is the primary distribution channel for both life and general business.** The agency channel generates 59 percent and 65 percent of new premiums (life) and gross premium (general), respectively. Bancassurance has also gained prominence in the recent years because insurers can leverage on the banks' existing network and customer base. Bancatakaful is the main distribution channels in family takaful sector with 53 percent contribution generated in 2011.

41. **The composition of insurance fund assets (including takaful business) remained similarly stable with private debt securities (PDS) continuing to form the majority of assets held** (Figure 1). Market and credit risk exposures arising from holdings of PDS remained manageable with the bulk of PDS held in high-grade papers (rated ‘A’ and above). Insurers reduced holdings in equities during the year to 15 percent of assets as at end-2011, in favor of less risky assets such as Malaysian government securities (MGS) and fixed deposits which accounted for 17 percent and 13.6 percent of the industry’s total assets, respectively. The rebalancing of investments maintained the market risk exposures of insurers at 12.6 percent of capital available, with interest rate risk from higher investments in MGS partly offset by lower equity risk exposures. Collectively, equity and interest rate risks formed 84.6 percent of insurers’ total market risk exposures (Figure 2).

**Figure 1. Insurance Sector: Composition of Assets**



**Figure 2. Insurance Sector: Component of Market Risk Exposure**



Source: Bank Negara Malaysia, FSPSR 2011.

42. **A significant component of life insurance businesses are investment-linked products which account for one third of the total new life business.** Demand for Investment-linked products has reduced significantly as a result of global market uncertainty. The potential of the life industry can be further harnessed through the holistic pension review being undertaken, including tax incentives to spur the private pensions industry.

43. **Takaful has experienced a double-digit growth in past five years with average annual growth of 24 percent.** Family takaful has contributed considerably to the growth in contributions compared to general takaful fund, accounting for 85 percent of total funds in 2011. Ordinary family products continue to be the key contributor to the new business, while in general business is dominated by motor takaful.

44. **Malaysia is not a country that has significant natural catastrophe risks.** While flooding events can lead to significant gross insurance losses, commercial risks tend to be the bigger source of large losses.

45. **The overall business retention level for general insurers is approximately 70 percent, but this varies widely by business class.** Use of reinsurance is more pronounced for large and specialized risks in the aviation, oil & gas and engineering classes of business, where reinsurance premium ceded amounted to 94 percent, 93 percent and 56 percent of total premiums, respectively. In contrast, for motor insurance, the dominant general insurance line in Malaysia, the retention rate approaches 90 percent. Malaysian insurers reinsure a substantial part of risks underwritten in the global reinsurance market, either directly or through reinsurance placements with Malaysian branches of foreign reinsurers.

46. **While premium growth declined in 2011, capital adequacy continued to remain strong.** Persistent low yields and investment losses have been a drag on profitability. Reinsurers recorded operating losses as claims from business interruption losses surged due to the floods in Thailand. This sharply increased the overall claims ratio for fire business (including cover for business interruptions) to 69 percent (2010: 36 percent). Underwriting losses for motor third-party bodily injury insurance continued to pose downward pressure on profitability with the claims ratio rising to a record high of 300 percent (2010: 280 percent). The overall motor claims ratio (including ‘comprehensive’ business), however, improved to 77 percent. Despite weaker profits, the combined capitalization level of the general and life insurance industry remained strong with the aggregate capital adequacy ratio (CAR) at 222 percent, well above the supervisory minimum capital requirement of 130 percent.

47. **All insurance sectors maintained strong average capital positions.** The life sector has shown a declining trend since 2009, while the average capital ratio for the general sector has strong gains.

### *Institutional Framework and Arrangements*

48. **Oversight of the Malaysian financial sector primarily performed by BNM and the Securities Commission (SC).** BNM supervises the banking sector (conventional, Islamic, investment<sup>6</sup> and development banks) as well as the insurance sector (including reinsurance and takaful). It also licenses financial advisors, insurance brokers, and money brokers, as well as oversees the money and foreign exchange markets; and the payment clearing and settlement systems. The SC regulates the securities industry as well as derivatives (other than exchange rate related OTC contracts). There is a stand-alone deposit protection agency (PIDM). The Labuan Financial Services Authority (LFSA) covers all offshore financial activities in Labuan (banking, insurance, fund management). The LFSA is chaired by the BNM Governor and has a close working relationship with BNM. The two main pension funds are state-owned and overseen by the Ministry of Finance. The SC

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<sup>6</sup> The SC shares responsibility for investment banks with BNM.

currently regulates the nascent private sector pension fund industry using fund management regulations; separate pension regulations are to be introduced soon.

49. **Malaysia is undertaking comprehensive changes to its legislative framework for the regulation and supervision of financial institutions.** Proposed legislation, referred to as the proposed Financial Services Act (FSA) and Islamic Financial Services Act (IFSA), aim to consolidate and rationalize existing regulatory laws to achieve a more cohesive legislative framework. A dual framework will be maintained for the conventional and Islamic financial business consistent with the dual financial system in Malaysia. Within this dual framework, the prudential and market conduct supervision of institutions and markets under BNM's purview will be integrated under the proposed new legislation, which will replace the existing Banking and Financial Institutions Act 1989, Islamic Banking Act 1983, Insurance Act 1996, Takaful Act 1984, Payment Systems Act 2003 and Exchange Control Act 1953. Included in the proposed legislative changes are provisions to allow BNM to exercise oversight over financial groups that have one or more licensed institutions within the group.

#### **D. Preconditions for Effective Insurance Supervision**

50. **The legal framework in Malaysia is based on the common law system.** Law is enforced through a single structured judicial system consisting of superior and subordinate courts whose decisions are enforceable, with avenues for appeal consistent with common law systems. In addition to the court system, alternative mechanisms for resolving disputes and debts allow judicial resources to be conserved, while expediting case disposals.

51. **Pursuant to the Companies Act 1965, companies are required to prepare their accounts based on approved accounting standards issued by the Malaysian Accounting Standards Board (MASB).** The financial statements should show a "true and fair" view of the financial positions, financial performance and cash flow of an entity.

52. **Public interest entities are required to report their accounts using Financial Reporting Standards (FRS) set by the MASB, which is in full compliance with International Financial Reporting Standards (IFRS) as set by the International Accounting Standards Board .** IFRS is directly transposed into Malaysian FRS, adapted where absolutely necessary. Any changes made are done with the sole objective of enhancing the quality of reporting, and typically deal with only specific issues not dealt with in the IFRS by illustrating or providing additional clarifications for better understanding or making changes necessary to comply with local laws and regulations.

53. **Companies' accounts are required to be audited annually by approved auditors.** Reports and the audit procedures performed are in compliance with National Auditing Standards, which are in full compliance with the International Standards on Auditing. Membership in the Malaysian Institute of Accountants (MIA) is a pre-requisite for employment in Malaysia as a professional accountant or auditor and all members are required to comply with the MIA By-Laws on Professional Ethics.

54. **Malaysia has a guarantee fund for the protection of owners of insurance policies and takaful certificates.** The Government has set up a Takaful and Insurance Benefits Protection System (TIPS), administered by PIDM to protect owners of takaful certificates and insurance policies from the loss of their eligible benefits in the unlikely event of an insurer member failure. TIPS, one of the components of the Enhanced Financial Consumer Protection Package established by PIDM was brought into effect on 31 December 2010. TIPS is funded by annual premiums paid by member institutions. Part of the reserves also came from the transfer of the Insurance Guarantee Scheme Fund, from BNM to PIDM. To be eligible for protection under TIPS, the takaful certificate or insurance policy must be issued in Malaysia by an insurer member and be denominated in Ringgit Malaysia. Based on the limits and scope of coverage, 95 percent of all Takaful certificates and insurance policy holders are protected in full.

### E. Key Findings and Recommendations

**Table 3. Summary Implementation of the ICPs**

<b>Insurance Core Principle</b>	<b>Comments</b>
1. Objectives, Powers and Responsibilities of the Supervisor	Existing legislation clearly defines BNM as the authority responsible for insurance supervision, and BNM's powers to administer and enforce the enabling legislation (subject to Ministerial approval in many cases) for insurance operators and intermediaries in Malaysia. Supervisory objectives could be more clearly defined.
2. Supervisor	<p>Legislation provides for BNM to be an operationally independent statutory body. It also affords BNM directors, officers, employees and others working on its behalf with appropriate legal protection, as well as requires them to protect confidential information. Internal governance practices emphasize committee decision-making, to promote soundness and consistency.</p> <p>BNM's operations are self-funded, with resourcing decisions fully within its control. It has a practice of overstaffing in order to address turnover issues, especially at entry-level positions. BNM offers a remuneration package that is comparable to the industry, invests significantly in staff training, and requires staff to follow a substantive code of conduct to promote high ethical standards. BNM staff members are highly regarded by industry stakeholders.</p> <p>The transparency of BNM's regulatory expectations, and the process for regularly reviewing their continued appropriateness, could be enhanced.</p>
3. Information Exchange and Confidentiality Requirements	<p>There is an adequate legal and administrative framework in place that allows BNM to exchange information, on entities it supervises, with other supervisors and authorities subject to confidentiality, purpose and use requirements.</p> <p>BNM does not have explicit power to regulate and supervise authorised financial or insurance holding companies and all their related entities, and so does not have legal authority to directly obtain information from such entities.</p>

Insurance Core Principle	Comments
	<p>BNM's home-host Supervisory Framework (HHSF) aims to address specific information sharing situations in a consistent manner. BNM has a very limited number of MOUs in place for insurance supervision purposes.</p>
4. Licensing	<p>Only licensed entities can lawfully conduct insurance activities in Malaysia. Legislation establishes clear parameters for the allowable legal forms and business activities of insurers, as well as the relevant licensing approval authorities and their applicable powers.</p> <p>In the absence of specific licensing criteria within legislation, BNM established specific guidelines and communiqués to articulate the licensing criteria, and information required for license application, during the limited rounds of BNM acceptance of reinsurer and (re)takaful applications since 1995. No direct conventional insurance licenses have been issued since the 1970s.</p> <p>The requirements and procedures for licensing are appropriately clear and adequately administered within the parameters of the insurance market for which access by new entrants is significantly restricted. In such circumstances, applications that best meet objective criteria are approved. Licensing approval criteria is not contained within existing legislation. The proposed FSA is expected to address this.</p>
5. Suitability of Persons	<p>An adequate legislative and BNM administrative framework exists to ensure that Board Members, Senior Management and Key Persons in Control Functions possess competence and integrity to fulfil their roles, both upon and subsequent to their (re)appointment.</p> <p>While significant owners are subject to suitability assessments upon application for approval for licensing and significant changes in their shareholdings, there are no requirements for significant owners to continually comply with suitability requirements. The proposed FSA is expected to address this.</p>
6. Changes in Control and Portfolio Transfers	<p>Legislation clearly defines 'control', and approval is required for share ownership transactions well below the level of 'control'. The approval regime for changes in an insurer's ownership is two-staged. The first relates to the commencement of negotiations, where BNM's prior approval is required for any party to enter into negotiations to transfer 5 percent or more shares of an insurer. The second stage involves the details of the arrangement that will result in the transfer of shares in an insurer, which under legislation requires the Minister's prior approval upon BNM's recommendation. BNM effectively uses licensing and suitability of persons criteria to assess such applications, which includes financial and non-financial requirements.</p> <p>Under legislation, any scheme of transfer for insurance or reinsurance business has to be approved by BNM, and confirmed by the court (if the transfer is in relation to business in Malaysia). Legal provisions and administrative processes exist to protect policyholders under such transactions.</p>

Insurance Core Principle	Comments
	<p>Legislation does not explicitly outline approval criteria for the acquisition of a significant ownership interests in insurers or for insurer portfolio transfers. The proposed FSA is expected to address this.</p>
7. Corporate Governance	<p>Legislation provides broad, but limited, corporate governance requirements. BNM outlines its corporate governance expectations for insurers through various guidelines. Overall, the guidance is extensive in scope and reflects high standards. The expectations are reinforced with insurers through BNM's supervisory focus on corporate governance and its mandatory training program for financial institution directors.</p> <p>Certain key corporate governance guidelines from BNM are due for review. In particular, one key guideline was issued about ten years ago and contains 'best practices' which are more appropriately elevated to mandatory standards based on BNM's expectations of insurers today.</p>
8. Risk Management and Internal Controls	<p>BNM outlines its risk management and internal control expectations for insurers through various guidelines. Overall, while the expectations articulated within BNM's risk management and internal controls related guidelines are wide in scope, and many reflect high standards, some key regulatory guidelines are due for review. In particular, one key guideline was issued about ten years ago and contains 'best practices' which are more appropriately elevated to mandatory standards based on BNM's expectations of insurers today.</p>
9. Supervisory Review and Reporting	<p>BNM's supervisory framework is an integrated risk-based system that uses both off-site monitoring and on-site inspections to assess the overall risk profile of insurers - based upon their business activities, inherent risks, quality of risk management, compliance with legislative and supervisory requirements, and financial and solvency condition.</p> <p>BNM collects extensive information, on both a regular and ad hoc basis, and as deemed necessary to conduct effective supervision of insurers and to evaluate the insurance market.</p>
10. Preventative and Corrective Measures	<p>The legislative, administrative and supervisory frameworks in place promote the ability for BNM to take timely, suitable and necessary preventative and corrective measures to achieve supervisory objectives.</p> <p>BNM's early intervention supervisory approach under its Supervisory Risk-based Framework (SuRF), and increasing supervisory intensity and severity of measures under its Supervisory Intervention Guide, allow for remedial actions to be taken by insurers before problems become worse. BNM is active in communicating prudential and non-compliance issues to insurers, as well as in indicating actions and timeframes for corrective actions to be taken.</p>
11. Enforcement	<p>The legislation and administrative framework in place provides BNM with the ability to pursue a wide range of enforcement actions. Many examples were identified where BNM utilized a wide-range of substantive enforcement powers under legislation. To ensure consistency, BNM decisions on enforcement actions are made through internal committee, but it does not make publically available information relating to the criteria or basis for its</p>

Insurance Core Principle	Comments
	<p>enforcement decisions or actions.</p> <p>While BNM does not have the authority to invoke some substantive enforcement actions without Ministerial approval, this has not been seen as practical impediment to BNM's enforcement activities. The expansion of available enforcement tools for BNM, and greater transparency of the basis of enforcement decisions, would enhance BNM's effectiveness.</p>
12. Winding-up and Exit from the Market	<p>There is an extensive legislative framework in place for the winding-up and exit of insurers from the market, which provides for a range of failure resolution options and appropriate priority protection for policyholders. Upon BNM's determination of insurance non-viability, PIDM is empowered to intervene and resolve troubled insurers, with the aim of minimizing costs to the financial system.</p>
13. Reinsurance and Other Forms of Risk Transfer	<p>BNM has a well-established legal and administrative framework with respect to the use of reinsurance, particularly for general insurers, with communicated expectations that insurers adequately control and report on their risk transfer programmes. BNM's supervisory activities reinforce good reinsurance management practices by insurers.</p> <p>BNM's key detailed guideline on reinsurance arrangements is due for review, and currently does not extend to life reinsurance.</p>
14. Valuation	<p>For solvency purposes, BNM effectively uses IFRS as the valuation basis with prescribed requirements in certain areas outlined in BNM guidance. The technical provisions reflect the present value of relevant cash flows, with a margin over current estimate (MOCE), and a requirement for discounting for life insurers.</p>
15. Investment	<p>Legislation and BNM guidelines set out prudential considerations for insurers' investment management activities. In particular, BNM's risk-based capital (RBC) guideline addresses investment management expectations as well as capital charges relating to investment risks. The guidelines do not fully reflect BNM's current expectations and do not address group-wide risks.</p>
16. Enterprise Risk Management for Solvency Purposes	<p>BNM has many guidelines that promote robust enterprise risk management by insurers and governance activities appropriate to the nature, scale and complexity of insurers operations. In particular, BNM's RBC guideline requires insurers to establish links between their risk and solvency capital management activities. BNM's planned near-term changes will address gaps it has identified, particularly with respect to risk governance and ICAAP expectations.</p>
17. Capital Adequacy	<p>BNM has a RBC framework to adequately and explicitly capture insurers' risks, on a total balance sheet basis, and provide for sufficient capital to absorb significant unforeseen losses. It provides two explicit triggers to allow for different degree of supervisory intervention. The RBC requirement is not defined in terms of level of protection provided.</p> <p>BNM has not developed a risk capital framework for financial guarantee insurance.</p>
18. Intermediaries	<p>Under legislation, BNM is empowered to license, regulate and supervise brokers and financial advisors. BNM conducts assessments of the</p>

Insurance Core Principle	Comments
	<p>compliance by broker and financial advisor with regulatory requirements, using that information as part of its process for license renewal decisions. Agents are subject to the various self-regulatory requirements set out by their industry associations. In practice, BNM works closely with those associations to ensure appropriate requirements are set out. Also, BNM periodically assess agents' compliance with those requirements as part of its supervisory activities at the insurer, and takes enforcement actions as necessary.</p> <p>Legislation does not require the maintenance of separate fiduciary accounts for monies collected from clients, but BNM indicates that this is observed in practice by all insurance brokers and financial advisors. This gap is expected to be addressed in the proposed FSA. Also, BNM is developing a supervisory approach more specific to the relevant considerations for intermediaries.</p>
19. Conduct of Business	<p>Through the issuance of various consumer protection guidelines, BNM has set many expectations for the conduct of business to ensure customers are treated fairly. BNM conducts market conduct surveillance activities to assess the adherence to its expectations. It is also involved in many consumer education initiatives.</p> <p>BNM's effectiveness could be enhanced with strengthened enforcement tools and the development and implementation of a supervisory framework specific to market conduct activities. Both measures are being currently undertaken.</p>
20. Public Disclosure	<p>BNM's public disclosure requirements leverage on requirements for all insurers to effectively report using IFRS, with some additional requirements imposed by various BNM guidelines. BNM actively promotes the public dissemination of insurer information, both through its public disclosure requirements on insurers, and through its own extensive publishing of insurer and industry data on its website.</p> <p>Beyond accounting requirements, BNM's additional public disclosure requirements are not extensive, and do not include certain disclosures currently viewed as useful by analysts/ market participants.</p>
21. Countering Fraud in Insurance	<p>Legislation has serious penalties for fraud activities. BNM has issued guidelines to industry on fraud prevention and control activities, collects insurance fraud data from insurers, conducts macro surveillance to determine insurance fraud trends, and examination activities assessing insurer anti-fraud practices, and periodically shares data and intelligence on fraud matters with police authorities.</p> <p>Supervisory practices could be enhanced to more specifically address insurers' anti-fraud activities.</p>
22. Anti-Money Laundering and Combating the Financing of Terrorism	<p>BNM is the designated AML/CFT competent authority in Malaysia. It has taken a number of measures to ensure insurers and intermediaries take effective measure to combat money laundering and the financing of terrorism, including the issuance of guidelines, supervisory AML/CFT reviews, and feedback sessions with industry.</p> <p>BNM's FIU is involved in various initiatives to identify issues and share information relating to money laundering and the financing of terrorism. BNM has signed 34 information sharing MoUs with foreign authorities.</p>

Insurance Core Principle	Comments
23. Group-wide Supervision	<p>There are no significant insurance groups for which BNM is the home supervisor, For insurers belonging to a foreign financial group, under its HHSF BNM shares information with other relevant supervisors as necessary to facilitate the supervision of group-wide risks.</p> <p>While BNM does not have explicit authority to regulate and supervise holding companies and their related entities, as part of its supervisory approach, BNM analyzes group entities for their ability to provide capital support and for activities that may pose a risk to the financial condition of the regulated entity. The group-wide analysis feeds into the development of the supervisory strategy for the regulated entity.</p> <p>While BNM's indirect approach mitigates some concerns, it is not an adequate substitute for the range of additional tools available when there is clear authority for group-wide supervision.</p>
24. Macroprudential Surveillance and Insurance Supervision	<p>BNM conducts many activities around identifying, monitoring and analyzing various market and financial developments, as well as other environmental factors, which may impact insurers and insurance markets. Such work is supported by the extensive data it collects from insurers and other sources, some of which it publicly discloses for transparency purposes.</p> <p>With some surveillance activities, a more structured approach would enhance BNM's effectiveness.</p>
25. Supervisory Cooperation and Coordination	<p>The Malaysian insurance sector has few insurance groups with cross-border operations, and the Malaysian operations of foreign-owned groups are small in relation to the overall operations of these foreign groups. There are no significant insurance groups or financial holding company for which BNM is home supervisor.</p> <p>Nevertheless, BNM has an adequate legal and administrative framework in place to allow it to effectively cooperate and coordinate with other relevant supervisors and authorities on matters relating to the entities it regulates, subject to confidentiality requirements. Many examples demonstrated BNM's openness to cooperating and coordinating with other relevant authorities.</p>
26. Cross-border Cooperation and Coordination on Crisis Management	<p>Given the relative size and structure of the Malaysian insurance industry, BNM expects that its role in effectively managing a cross-sector crisis involving an insurer would be limited in most cases.</p> <p>BNM has an adequate legal and administrative framework in place to allow it to effectively cooperate and coordinate with other relevant supervisors and authorities on matters relating to the entities it regulates. BMN also has demonstrated its openness to cooperating/ coordinating with other relevant supervisors and authorities.</p> <p>BNM could further enhance its ability to contribute to the effective resolution of an insurer cross-border crisis by increasing its expectations of insurers to maintain comprehensive contingency plans and information systems capable of generating timely and reliable ad hoc information on risk accumulation</p>

**Table 4. Recommendations to Improve Observance of the ICPs**

Insurance Core Principle	Recommendations
1. Objectives, Powers and Responsibilities of the Supervisor	To reduce the possibility of conflicting supervisory functions, legislative amendments should be made to more specifically highlight the application of BNM's principal objectives to the supervision of the insurance sector for the benefit and protection of policyholders. This is expected to be addressed in the proposed FSA.
2. Supervisor	As transparency promotes greater accountability, BNM should move forward with its plans to formalize a policy development framework and establish a more liberal approach towards public disclosure of its regulatory expectations. Subsequent to the assessment, BNM indicated that the policy development framework was rolled out for implementation in May 2012.
3. Information Exchange and Confidentiality Requirements	BNM's should participate in more extensive MOU arrangements (including the IAIS MMOU) with other supervisors so as to have a stronger foundation for ensuring appropriate protection of shared information.
4. Licensing	In order to better support the consistent administration of licensing standards, clear and objective licensing approval criteria should be incorporated within legislation. BNM has indicated that proposed FSA aims to do this.
5. Suitability of Persons	Legislative amendments should be made to require significant owners to continually comply with suitability requirements, and provide substantive powers to adequately address situations where significant owners no longer meet such requirements. This is expected to be addressed in the proposed FSA.
6. Changes in Control and Portfolio Transfers	To ensure greater consistency of requirements and approval objectives, and reduce the potential of undue political interference in transactions requiring Ministerial approval, legislation should more explicitly define the approval criteria for acquisitions of a significant ownership interests and portfolio transfers. This is expected to be addressed in the proposed FSA.
7. Corporate Governance	To ensure the continued appropriateness and clarity of its corporate governance expectations, BNM should update and consolidate its related guidelines where appropriate. In doing so, BNM should take into consideration the recent updates made to the <i>Malaysian Code on Corporate Governance</i> , by the SC, that are to be implemented beginning later this year by the companies listed on Bursa Malaysia.
8. Risk Management and Internal Controls	To ensure the continued appropriateness and clarity of its risk management and internal control expectations for insurers, BNM should update its related guidelines where appropriate.  The finalization and implementation of BNM's recent concept paper on risk management governance, which BNM indicates would occur in late 2012, should assist in addressing identified gaps.
9. Supervisory Review and Reporting	BNM's SuRF may not be appropriate for use on certain types of supervisory reviews, Such concerns are outlined within the assessment of other ICPs.

Insurance Core Principle	Recommendations
10. Enforcement	<p>To enhance the structure and effectiveness of the enforcement regime, consideration should be given to:</p> <ul style="list-style-type: none"> <li>• Better aligning the need for Ministerial approval for enforcement actions within legislation with clearer objectives and purpose for such powers;</li> <li>• Enhancing the range and options of the enforcement tools available to BNM, and the deterrence measures within legislation; and</li> <li>• Making the criteria or basis for BNM’s enforcement decisions or actions more transparent.</li> </ul> <p>The above is expected to be addressed in the proposed FSA.</p>
11. Winding-up and Exit from the Market	<p>To ensure greater understanding and consistency in intervention and resolution practices, consideration should be given to more clearly defining ‘non-viability’ triggers within legislation.</p>
12. Reinsurance and Other Forms of Risk Transfer	<p>To ensure the continued appropriateness and sufficient scope of its reinsurance management expectations for insurers, BNM should update and expand its related guidelines where appropriate.</p>
13. Valuation	<p>BNM indicated that it plans to conduct more detailed assessments and benchmarking of the methods used to for MOCE determination, so as to strengthen processes, promote better comparability, and ensure regulatory objectives are being met.</p> <p>BNM should review the extent to which current valuation approaches for solvency purposes adequately meet regulatory objectives during ‘normal’ stress periods, so that temporary adjustments to valuation approaches need only be considered during truly anomalous economic conditions, such as those existing around 2008-09.</p>
14. Investment	<p>BNM should review its investment related guidelines to identify and implement further enhancements, which should include expectations on insurers’ use of external credit ratings and investment aggregation risks on a group-wide level.</p>
15. Enterprise Risk Management for Solvency Purposes	<p>BNM’s planned near-term changes will address many current gaps and insurance sector inconsistencies within its enterprise risk management expectations for insurers, particularly the implementation of its new ICAAP requirements and its draft <i>Risk Management Guidelines – Risk Governance</i>.</p>
16. Capital Adequacy	<p>BNM should give consideration to explicitly addressing interdependencies between and within risk categories within the RBC framework. Also, for greater clarity of RBC objectives, BNM should consider more explicitly defining the RBC in terms of the level of risk protection that it should afford, provided that BNM is satisfied that appropriate insurer competencies as well as market depth and liquidity exist to support such an initiative.</p> <p>In addition, to better promote prudent practices, BNM should establish definitive project plans for the near term development and implementation of a regulatory capital framework for financial guarantee insurance.</p>

<b>Insurance Core Principle</b>	<b>Recommendations</b>
17. Intermediaries	<p>To substantively enhance the regulatory regime for insurance intermediaries, legislative changes should be made to codify requirements for the maintenance of separate fiduciary accounts for monies collected from clients and to strengthen enforcement powers. This is expected to be addressed in the proposed FSA.</p> <p>Also, to ensure supervisory effectiveness, BNM should further develop a supervisory approach more specific to the relevant considerations for intermediaries.</p>
18. Conduct of Business	<p>To enhance effectiveness, legislative amendments should be made to strengthen enforcement powers and enhancements made to BNM's market conduct supervisory function and practices. This is expected to be addressed in the proposed FSA.</p>
19. Public Disclosure	<p>BNM should give consideration to enhancing its public disclosure regime for insurers through additional requirements for disclosures of disaggregated information on key measures such as insurer source of earnings and capital adequacy measures and risks/risk management processes.</p>
20. Countering Fraud in Insurance	<p>BNM should give consideration to reviewing the effectiveness and rigour of SuRF in adequately capturing and assessing insurer anti-fraud practices and issues.</p>
21. Anti-Money Laundering and Combating the Financing of Terrorism	<p>BNM should utilize its FIU specialists on AML/CFT supervisory reviews of insurers with significant sales of products having a higher susceptibility to money laundering risks.</p>
22. Group-wide Supervision	<p>Legislative amendments should be made to provide BNM with explicit powers to regulate and supervise holding companies and related entities. The proposed FSA is expected to explicitly empower BNM to regulate and supervise holding companies and all its related entities</p>
23. Macroprudential Surveillance and Insurance Supervision	<p>BNM utilizes macroprudential surveillance tools appropriate to the nature, scale and complexity of the insurance sector. Enhancements could be made by:</p> <ul style="list-style-type: none"> <li>• Requiring insurers to conduct periodic comprehensive industry-wide standardized scenario testing exercises, this would provide BNM with an additional tool for assessing the build-up of industry risks/ vulnerabilities;</li> <li>• Establishing a more structured internal processes for identifying, assessing, monitoring and reporting on emerging risks in the industry; and</li> <li>• Developing more robust indicators for assessing systemic risk of insurers.</li> </ul>
24. Supervisory Cooperation and Coordination	<p>Recommendations on related matters of group-wide supervision and information sharing considerations are addressed in assessments of other ICPs.</p>

Insurance Core Principle	Recommendations
25. Cross-border Cooperation and Coordination on Crisis Management	BNM should further enhance its ability to contribute to the effective resolution of a cross-border crisis by articulating its expectations of insurers to maintain: <ul style="list-style-type: none"> <li>• Comprehensive contingency plans; and</li> <li>• Information systems capable of generating timely and reliable ad hoc information on accumulation of risks.</li> </ul>

## F. Authorities' Response to the Assessment

55. **Bank Negara Malaysia (the Bank) welcomes the assessment on Malaysia's observance of the Insurance Core Principles (ICPs).** The assessment affirms the Bank's continuing efforts to maintain an effective regulatory and supervisory framework in ensuring the safety and soundness of the insurance and takaful industry in Malaysia. The assessment also makes recommendations that largely correspond with the Bank's current priorities to further strengthen the regulatory and supervisory system, and validates the various initiatives that are at advanced stages of implementation or for which definite plans have been put in place. We thank the assessors for the candid and open discussions, and the fruitful exchange of views throughout the assessment process.

56. **A significant number of the recommendations will be addressed by the proposed financial services legislation.** Amongst others, this will provide greater transparency in licensing standards and suitability requirements for shareholders. It will also further enhance powers for the Bank to take timely enforcement and corrective actions, and provide for the regulation and supervision of holding companies. Legislative changes and enhancements to the supervisory framework will also strengthen market conduct standards across the industry, including for intermediaries, and further reinforce financial integrity. The Bank's policy development framework, which was implemented in May 2012, will provide a well-defined process for the development and communication of regulatory expectations going forward. An important part of this process includes the regular review of regulatory standards issued by the Bank to clarify, update and enhance the standards as necessary to reflect the changing environment.

57. **In line with increasing regional and international financial integration, the Bank is also committed to further strengthening its existing cooperation and exchange of information arrangements with other supervisors and authorities, including through wider participation in bilateral MOUs and by enhancing capabilities to support effective cross-border crisis management and resolution.** The Bank will also continue with efforts to introduce more advanced tools for monitoring of systemic risks in the insurance sector.

### III. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

#### A. Summary, Key Findings, and Recommendations<sup>7</sup>

58. **The Securities Commission Malaysia (SC), as the supervisor of the capital markets, has developed a robust supervisory framework that exhibits high levels of implementation of the International Organization of Securities Commissions Objectives and Principles of Securities Regulation (IOSCO Principles) in most areas.** The regimes governing the regulation of issuers, auditors, collective investment schemes, market intermediaries and secondary markets, and with respect to enforcement, co-operation and information sharing, are extensive.

59. **There are, however, some areas where enhancements are advisable.** The SC's independence would be buttressed by some changes to the legal provisions on removal of commission members and to protections given to the members of the Commission and to its staff. The disclosure deadlines for issuers and their substantial shareholders should be adjusted to reflect international best practices. The new frameworks for oversight of credit rating agencies and the Federation of Investment Managers Malaysia should be implemented in full by carrying out on-site inspections as presently planned. At this stage in the jurisdiction's development, consideration should also be given to putting in place the pre-conditions that will enable the SC to ease up gradually on the intensity of its direct involvement in the day-to-day operations of the capital market and its participants.

#### B. Institutional and Market Structure—Overview

60. **The Malaysian financial system is regulated by two main authorities: the SC and BNM.** Both report to the Minister of Finance. They have clearly delineated areas of oversight and accountability set out in legislation. Formal arrangements govern areas of joint responsibility, such as investment banks, and give the SC authority to approve capital markets products designed, operated and offered by institutions licensed by BNM.

61. **The SC is a regulatory authority with broad powers to regulate the capital markets in operation in Malaysia; its responsibilities, powers and authority with respect to the capital market are established by statute.**<sup>8</sup> It has regulatory authority over equity securities, debt securities and derivatives, whether traded over-the-counter (OTC) or on organized markets, as well as other capital markets activities such as discretionary portfolio management and the management of collective investment schemes (CIS—or unit trusts).

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<sup>7</sup> The assessment was conducted by Tanis MacLaren (consultant to the IMF) using the 2011 IOSCO Methodology for Assessing Implementation of the IOSCO Principles (the Assessment Methodology).

<sup>8</sup> SC draws its powers from several laws, including the Securities Commission Act 1993 (SCA), Capital Markets and Services Act 2007 (CMSA) and Securities Industry (Central Depositories) Act 1991 (SICDA).

The SC has authority to make binding regulations, as well as issue guidelines and practice notes on products and services offered in both the conventional and Islamic segments of the capital market. The statutes have been supplemented with detailed secondary legislation in almost every area of the SC's authority.

62. **BNM is the central bank and the supervisory authority for a broad array of financial institutions operating in Malaysia.** In addition to being the supervisor of the banking and insurance sectors, BNM has oversight over the foreign exchange and money markets. The BNM reports to the Finance Minister.

63. **The SC is led by a nine member Commission headed by an Executive Chairman.** The Commission meets monthly to deliberate on matters such as appeals and Commission policies. Other than administrative and day-to-day matters, all functions of the SC, including approvals associated with its gate-keeping authority and oversight of the capital market, are vested with the Commission. Two affiliated agencies were established to complement SC's core functions: the Securities Industry Dispute Resolution Centre (SIDREC) and the Securities Industry Development Corporation (SIDC).

- **SIDREC** is a specialized dispute resolution body which facilitates prompt settlement of claims against certain licensed market intermediaries. It provides dispute resolution services for any dealing or transaction involving capital market products or services. The process involves both mediation and, where necessary, adjudication by SIDREC.
- **The Audit Oversight Board (AOB)** is part of the SC, but is governed by a separate board made up of representatives from the accounting profession, regulators including the SC, BNM and the Companies Commission Malaysia, and the private sector. It provides independent audit oversight of public interest entities (PIEs).

64. **The SC currently is prescriptive in how it executes its mandates with respect to regulating and developing the capital markets.** The SC has been very involved in most aspects of how the capital markets and their participants operate; and this risks leaving the Malaysian markets somewhat constrained when they face competition in the region, both for capital and market share. But the SC is starting to take a less prescriptive approach to regulating and developing the market. It has issued two documents recently—the Capital Market Masterplan 2 (CMMP2), which sets out SC's strategic direction in structurally reforming and developing the market, and the Corporate Governance Blueprint 2011. CMMP2 was launched in 2011, with the theme 'Growth with Governance'. The thrust is to complement regulatory discipline with self- and market-discipline. Given these plans, the SC appears to be giving due consideration to moving a less directive mode of regulation. For example, it has a strategy in place to give more emphasis on disclosure and less emphasis on merit reviews of new issues. These efforts should be encouraged.

65. **There is one securities exchange (Bursa Malaysia Securities) and one derivatives exchange (Bursa Malaysia Derivatives) operating under authorization granted by the**

**Minister.** Both, along with the securities and derivatives clearing houses, central securities depository and the operator of an electronic trading platform for the trading and reporting of bonds, are subsidiaries of the Bursa Malaysia Berhad holding company. The securities exchange has two equity markets—the Main Market and the ACE Market (for companies that have good growth potential but insufficient history to qualify for the Main Market). Bond trading takes place OTC but trades must be reported for transparency purposes.

66. **The regulatory structure in Malaysia makes use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for certain market participants.** Their rules are subject to meaningful sanctions. The two SROs are Bursa Malaysia and the Federation of Investment Managers Malaysia (FIMM). FIMM is a recognized and authorized SRO, responsible for the supervision of participants in the unit trust market (including registration of distribution agents). Bursa Malaysia is recognized as an exchange holding company, but undertakes certain functions of an SRO and is the front line regulator of stockbrokers and futures brokers and participants in the clearing houses.

67. **There are two components to the capital markets in Malaysia, conventional and Islamic; but the latter has not been assessed separately in this review.** The Assessment Methodology does not distinguish between conventional and Islamic markets with respect to expectations or standards. In any event, owing to the way the two markets are regulated in this jurisdiction, the ratings are equally applicable to both. The Islamic market operates parallel to the conventional market. The fundamental securities regulatory scheme for each market is similar, but with an additional set of requirements layered on top to ensure the Islamic products and services are Shariah-compliant. SC is guided by the Shariah Advisory Council (SAC), made up of Islamic finance and Shariah experts.

### C. Preconditions for Effective Securities Regulation

68. **The preconditions for effective supervision (a stable macroeconomic environment, sound legal and accounting framework, and effectiveness of procedures for the efficient resolution of problems in the securities market) appear to be in place.** There are specialized courts with expertise to deal with complex commercial matters, including capital markets transactions. The Companies Act contains comprehensive provisions relating to the management of the company, rights of shareholders, duties of directors and officers, preparation of company accounts and audit, issuance of shares and debentures, proceeding of general meetings and the winding up of companies. If a company is publicly listed, the CMSA and the Listing Requirements of the exchange prescribe additional requirements. Take-overs and mergers are governed by the CMSA and the Code on Take-overs and Mergers (the latter has statutory backing and is enforceable by the SC).

69. **The bankruptcy legislation is dated, but is under review and is expected to be substantially amended in the near future.** However, the CMSA provides for modifications to the laws of insolvency and miscellaneous provisions in relation to the default procedures

of the clearing house. If any participant of Bursa Malaysia becomes insolvent, trades on the securities and derivatives exchanges continue to be enforceable.

#### **D. Main Findings**

70. **Principles 1–8, relating to the regulator:** The SC has clear statutory authority over and responsibility for the Malaysian capital markets. In practice, the SC has operational independence. Its independence at law is somewhat impaired as the Minister has the right to dismiss any member of the Commission without cause at any time. The statutory immunity of Commission members and staff members does not extend to cover former employees and agents. Persons affected by decisions of the SC are afforded a full range of protections, including the right to be heard, to written reasons and to rights of appeal. The SC's staff are subject to detailed conduct rules. The SC has an explicit mandate and authority for monitoring, mitigating and managing systemic risk. Regulatory processes are in place to carry out this mandate and communication and information sharing between SC and BNM. The perimeter of regulation is assessed regularly; where developments in the market require action, the SC can exercise its public interest jurisdiction to block problematic behavior or products or change the relevant rules to permit new services and products. The SC, issuers, intermediaries, credit rating agencies (CRAs) the Bursa, FIMM and CIS are subject to extensive requirements regarding the management and disclosure of conflicts of interest.

71. **Principle 9, relating to self-regulation:** The two SROs, Bursa Malaysia and FIMM, are subject to the oversight of the SC and are required to observe high standards of conduct. The regime applicable to Bursa Malaysia is detailed, comprehensive and has been operating effectively for several years. The SC has recently established the supervisory framework for FIMM as an SRO. As at the date of the review, the SC had not yet conducted an on-site examination of FIMM, though other modes of oversight were operative.<sup>9</sup>

72. **Principles 10–12, relating to enforcement of securities regulation:** The SC has broad inspection, investigation and surveillance powers; and can investigate and take action against anyone who breaches the laws it administers. The SC carries on active inspection and enforcement programs. Both on-site and off-site reviews of regulated entities are performed.

73. **Principles 13–15, for cooperation in regulation:** The SC has the ability and capacity to share information and cooperate with regulators, both domestically and internationally. There is no requirement that there be an MOU in place. The SC has specific authority to provide assistance to a foreign supervisory authority to investigate an alleged breach of a legal or regulatory requirement. The SC is a signatory to the IOSCO Multilateral MOU and to many bilateral MOUs with its counterparts in other countries.

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<sup>9</sup> An on-site inspection of FIMM has since been carried out.

74. **Principles 16–18, for issuers:** Extensive requirements are in place for initial offering and continuous disclosure documents for securities. New issues of securities to the public must have prospectuses registered by the SC. Virtually all public issues of equity securities are listed on the Bursa and subject to the CMSA, SC guidelines and the Listing Requirements. Continuing disclosure documents are made public through the Bursa. Investors are treated equitably with respect to voting, access to information and the ability to participate in any takeover bid. As of January 2012, Malaysia implemented International Financial Reporting Standards (IFRS) for all PIEs, which includes public companies, CIS, financial institutions and market intermediaries. The publication of annual audited financial statements and annual reports by listed companies is slow compared to the requirements that apply to CIS. The notice period for shareholder meetings may be too short for full communication with all shareholders. Substantial shareholders in listed companies are given much longer to report their initial positions and any changes than are the directors and the CEOs of these issuers. The definition of 'interests in securities' does not include publicly offered rights. There is no timely public transparency of information on the positions of these key personnel for unlisted public companies.

75. **Principles 19–23, for auditors, credit rating agencies and other information service providers:** Auditors of PIEs are subject to appropriate levels of oversight, and must be registered with the AOB. There are extensive requirements for auditors to be independent of the entities they audit and these requirements are enforced by the AOB. The regulatory framework in Malaysia requires that the financial statements included in public offering and listing particulars documents and publicly available annual reports be audited in accordance with the International Standards on Auditing, for all periods beginning on or after January 1, 2010. CRAs whose ratings are used for regulatory purposes are subject to registration; bonds issued in ringgit must be rated. The SC has full power to supervise these entities. The SC has a framework in place to conduct on-site examinations of CRAs. As of the date of the review, SC had yet to conduct an on-site examination of a CRA (one has since been completed). Investment advisors/analysts, corporate finance advisors and bond pricing agencies have to be licensed or registered with the SC.

76. **Principles 24–28, for collective investment schemes and hedge funds:** All publicly offered CIS and their operators and distributors are subject to authorization and reporting requirements. All funds offered to the public must be approved by the SC: this includes the review of a prospectus that contains comprehensive and timely information. Funds are established as unit trusts, with assets segregated from those of the operator and distributor and held by an independent trustee approved by the SC. All CIS and their operators and distributors are subject to a comprehensive supervision framework that includes both off-site and on-site reviews. The fund's securities and its assets are subject to valuation in accordance with IFRS. Continuous disclosure of unit prices is provided through the FIMM website. A hedge fund can be set up under the wholesale framework to offer securities only to qualified (sophisticated) investors and must be approved by the SC. Wholesale funds are also subject

to requirements to report regularly to investors and to the SC, including delivery of audited annual reports within two months of the fund's year end.

77. **Principles 29–32, for market intermediaries:** A framework is in place for licensing and to apply on-going requirements for market intermediaries. Applicants are subject to detailed reviews before being licensed. There are initial and ongoing capital requirements for all types of intermediaries that reflect the risks undertaken. The capital requirements for stock-broking and futures broking companies address the full range of risks, including market, credit, liquidity and operational risk. There are requirements regarding immediate reporting of deficiencies. Market intermediaries are required to have extensive systems of risk management and internal controls in place. There are regulations for protection of clients, including segregation of clients' assets and business conduct rules. The SC plans for dealing with a firm's failure include action to restrain conduct, to ensure client's assets are properly managed and to provide relevant information to the regulators and the general public.

78. **Principles 33–37, for the secondary markets:** Exchanges are subject to authorization by the Minister with the advice of the SC. The monitoring activities conducted by Bursa Malaysia include conducting real-time surveillance of the market and supervision of its participating members and clearing members. Market surveillance for trading on the securities market is performed at the exchange and the SC in parallel. The SC has a comprehensive oversight system for exchange supervision that includes on-site examinations and off-site reviews of rules and other matters. The SC may suspend the operations of a stock exchange or Registered Electronic Facility (REF). On the recommendation of the SC, the Minister may revoke the authorization of any exchange; the SC may revoke an REF's registration. There is both pre-trade and post-trade real-time transparency of prices on the Bursa exchanges, other than for certain specified trades subject to clearly defined conditions. The rules against market abusive transactions are extensive and there are mechanisms to detect and take action against improper conduct. Trades on both the securities and derivatives exchanges are cleared and settled through central counterparties that have detailed and transparent provisions designed to protect the markets against a default by any participant.

**Table 5. Summary Implementation of the IOSCO Principles—Detailed Assessments**

Principle	Findings
1. The responsibilities of the Regulator should be clear and objectively stated.	The SC has clear statutory authority over and responsibility for the Malaysian capital markets. Where there are overlaps between the SC and BNM with respect to market participants, the securities legislation is designed to minimize regulatory differences or gaps. There are arrangements in place between the two authorities to support equivalent protections for investors and to coordinate regulatory activities.
2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	The SC in practice has a high degree of independence from the government and industry and its internal processes and governance reinforce that independence. However, there are gaps in the provisions of the law that support independence of action by the Commission members and staff that need to be addressed. Persons affected by decisions of the SC are afforded a full range of protections, including the right to be heard, to written reasons and to rights of appeal.
3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	The SC has sufficient powers to carry out its functions under the securities laws. The SC responsibilities, powers and authorities are set out in securities laws. It has full authority to license, inspect, enforce and regulate the participants in the capital market in Malaysia. It has the statutory power to make legally enforceable regulations and guidelines. The SC's funding is adequate to permit it to fulfill its responsibilities. The SC has policies and governance practices in place to guide the performance of its functions and exercise of its powers. The SC places a significant emphasis on investor education as a key component of its investor protection mandate.
4. The Regulator should adopt clear and consistent regulatory processes.	There are processes and procedures adopted within the SC to ensure that regulatory actions undertaken by the SC are fair and reasonable, transparent and comprehensible to the affected persons and the marketplace, and that there is consistent application of relevant principles. There is a notable level of transparency in how the SC operates and all laws, regulations, guidelines etc. are available on the website. Persons affected by decisions of the SC are afforded a full range of protections, including the right to be heard, to written reasons and to rights of appeal.
5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	SC staff observe high standards of professional conduct and are subject to detailed ethical and conduct rules. Any violation or infringement of provisions of any applicable law, the Code of Conduct, the Terms and Conditions of Employment and any conduct on the part of the staff member that is inconsistent with the faithful discharge of duties towards the SC would be construed as misconduct. Misconduct may result in the institution of disciplinary proceedings.
6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.	The SC has an explicit mandate and authority for monitoring, mitigating and managing systemic risk. There are regulatory processes in place to carry out this mandate and communication and information sharing between the Commission and BNM. It is invited to participate in meetings of the Financial Stability Executive Committee (FSEC) only when capital markets issues have been identified as a topic of discussion.

Principle	Findings
7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	The perimeter of regulation is assessed regularly and where developments in the market require action, the SC can take action. If the developments are of concern, it may exercise its public interest jurisdiction to block problematic behaviour or products. If the existing rules are blocking positive developments, such as new services and products, the guidelines and rules may be changed. The SC has good access to the legislative agenda where changes to the law are required.
8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.	The SC has processes in place to address conflicts of interest and misalignment of incentives. The SC staff, issuers, intermediaries, the Bursa, FIMM, CRAs and CIS are subject to extensive requirements regarding the avoidance, mitigation, management and disclosure of conflicts of interest.
9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	There are two organizations in the Malaysian capital markets that exercise some direct oversight responsibility for certain markets and market participants. Both Bursa Malaysia and FIMM are subject to the oversight of the SC and are required to observe high standards of conduct in carrying out their tasks. The regime applicable to Bursa Malaysia is detailed, comprehensive and has been operating effectively for many years. FIMM, for many years, has had a quasi-regulatory role with respect to supervision of unit trust marketing and distribution activities, largely with respect to individual sales personnel and has been subject to the supervision of the SC in that regard. It was recognized as an SRO in January of 2011 after a full application process and review and is subject to extensive reporting requirements under the law and its conditions of recognition. The supervisory framework for FIMM includes on- and off-site supervision, reporting and a rule review process. While the first on-site regulatory examination is scheduled to take place in the next quarter, there is evidence that the SC takes action where issues are identified from reports filed, complaints or from other sources. Note that the first on-site inspection of FIMM was carried out in May, 2012. The SC retains full authority to oversee Bursa Malaysia and FIMM members and registrants.
10. The Regulator should have comprehensive inspection, investigation and surveillance powers.	The SC has broad inspection, investigation and surveillance powers.
11. The Regulator should have comprehensive enforcement powers.	The SC has broad powers to investigate and take action against anyone who breaches the laws it administers.
12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	Both on-site and off-site reviews of regulated entities are performed by the SC. Bursa Malaysia performs on and off-site reviews of its participant firms. Market surveillance is performed at the exchanges and at the SC. The SC and Bursa Malaysia conduct reviews of continuing disclosure information provided by listed companies. Market intermediaries must have effective compliance systems.

Principle	Findings
13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.	The SC has the ability and capacity to share information and cooperate with regulators, both domestically and internationally. It can share confidential information with any other foreign regulatory authority and has a record of active cooperation.
14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	The SC is a signatory to the IOSCO Multilateral MOU and to many bilateral MOUs with its counterparties in other jurisdictions.
15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	The SC may provide extensive assistance to foreign regulatory authorities in carrying out their responsibilities, including by obtaining and sharing information and cooperating on inspections. The SC does not require the permission of any outside authority to share information and an independent interest or dual illegality is not required as a precondition to cooperation.
16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	Extensive requirements are in place for offering and continuous disclosure documents for securities. The disclosure to be provided to futures contract purchasers is specified under the law and the rules of the Bursa Malaysia Derivatives. New issues of securities (debt, equity or collective investment schemes) to the public are required to be offered via prospectus that must be registered by the SC. Virtually all public issues of equity securities are listed on the Bursa Malaysia and are subject to the provisions in the Listing Requirements. The SC approves listings on the Main Market of Bursa Malaysia and the Bursa approves listings on the ACE Market. Continuous disclosure documents are made public through the facilities of the exchange. The publication deadlines for annual reports and audited financial statements by public companies are long compared to international standards and very long when compared to the reporting period required for CIS in the jurisdiction.
17. Holders of securities in a company should be treated in a fair and equitable manner.	Investors are treated equitably with respect to voting, access to information and the ability to participate in any takeover bid. Full information must be provided for any takeover bid. The notice period for shareholder meetings is fairly short and there are limitations in the corporate law in the use of proxies that may hamper fully effective exercise of shareholders' voting rights. Substantial shareholders in listed companies are given much longer to report their initial positions and any changes than are the directors and CEOs of these issuers. Other members of the senior management have very limited disclosure obligations. The definition of 'interests in securities' does not include publicly offered rights. There is no timely public transparency of information on the positions of these key personnel for unlisted public companies.

<b>Principle</b>	<b>Findings</b>
18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	All Public Interest Entities (PIEs), which include public companies, collective investment schemes, financial institutions and market intermediaries are required to prepare their financial statements using International Financial Reporting Standards (IFRS).
19. Auditors should be subject to adequate levels of oversight.	There is a system in place in Malaysia that subjects auditors of PIEs to appropriate levels of oversight. Auditors of PIEs must be registered with the Audit Oversight Board (AOB), which is a business group of the SC. The AOB conducts examinations of auditors and has the power to sanction breaches of the standards.
20. Auditors should be independent of the issuing entity that they audit.	There are extensive requirements for auditors to be independent of the entities they audit and these requirements are enforced by the AOB.
21. Audit standards should be of a high and internationally acceptable quality.	The financial statements included in prospectuses, listing documents and publicly available annual reports must be audited in accordance with the International Standards on Auditing issued by the International Federation of Accountants.
22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and on-going supervision.	Credit rating agencies (CRAs) whose ratings are used for regulatory purposes are subject to registration; bonds issued in ringgit must be rated. The SC has full power to supervise these entities, including the power to carry out on-site and off-site examinations and sanctioning. The SC has had a supervisory framework in place for these agencies since 2006 that included off-site review and engagement with management where deficiencies were noted. At the time of the review, while the SC had yet to conduct an on-site examination of a CRA, there is evidence of active and extensive review of the activities of the CRAs and investigation into any problematic issues identified. An on-site inspection of one of the two domestic CRAs was carried out, beginning in the first week of May 2012, and has since been completed.
23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.	Entities that provide analytical or evaluative services include investment advisors/analysts, corporate finance advisors, bond pricing agencies and property valuers. Investment advisors/analysts, corporate finance advisors and bond pricing agencies have to be licensed or registered with the SC. Property valuers are professionals registered with the Board of Valuers under the purview of the Ministry of Finance.
24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.	All CIS offered to the public and their operators and distributors are subject to authorization and reporting requirements. The requirements for licensing by the SC require the operator and fund manager (portfolio manager) to have in place appropriate organizational and operational structures, including risk management systems and internal controls. All CIS and their operators and distributors are subject to a comprehensive supervision framework that includes both off-site and on-site reviews. Outsourcing is permitted for some activities but is subject to detailed requirements.

Principle	Findings
25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	Funds are established as unit trusts, with assets segregated from those of the operator and distributor and held by an independent trustee that must be approved by the SC.
26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	All funds offered to the public must be approved by the SC, which process includes the review of a detailed prospectus that contains comprehensive and timely information about the CIS. Material changes require prompt notice and usually the amendment of the prospectus. Prospectus amendments are subject to review by the SC prior to registration.
27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.	The fund's securities and its assets are subject to valuation in accordance with IFRS. Continuous disclosure of unit prices is provided through the FIMM website. The prospectus of the fund must contain information about valuation, pricing and the applicable provisions governing purchase and redemption of funds.
Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.	There is no special definition of hedge fund in the jurisdiction. CIS, including hedge funds, can be set up under a clearly defined wholesale framework to offer securities only to qualified (sophisticated) investors. These funds must be approved by the SC. The operator must be licensed by the SC as a fund management company and are subject to inspection under the risk-based supervision program that applies to all market intermediaries. The offering memorandum containing specified information about the fund must be deposited with the SC. These wholesale funds are required to provide regular reporting to their investors and to the SC, including preparing annual audited reports within two months of year end.
29. Regulation should provide for minimum entry standards for market intermediaries.	A framework is in place for licensing and to apply on-going requirements for market intermediaries. Applicants are subject to detailed off-site reviews before being licensed. All firms that are applying to be Bursa Malaysia participants are subject to extensive on-site readiness assessments of their operations and systems by Bursa Malaysia before they are approved. For FMCs, the SC does an on-site check once business has commenced to ensure operations are functioning as required. Certain other licensees are subject to requirements for external audits after beginning operations to confirm systems are effective.
30. There should be initial and on-going capital and other prudential	There are initial and ongoing capital requirements for all types of intermediaries to ensure that they have adequate resources to meet their business commitments and address the risks of their businesses. The

Principle	Findings
requirements for market intermediaries that reflect the risks that the intermediaries undertake.	capital requirements for stockbroking and futures broking companies specifically address the full range of risks to which the firms are exposed, including market, credit, liquidity and operational risk. The capital formulae for other intermediaries are fairly simple, reflecting the nature of their operations that are carried on in practice. FMCs are permitted to carry on proprietary trading but a large majority of the positions held raise few risks and the activity is subject to extensive monitoring by the SC. There are requirements regarding capital calculations and immediate reporting of deficiencies by market intermediaries.
31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.	Market intermediaries are required to have extensive systems of risk management and internal controls in place. The firm's internal audit function must review these systems annually and the results of that review must be reported to the Board of Directors of the firm. There are regulations for proper protection of clients, including requirements for segregation of clients' assets and business conduct rules, such as 'know your client' and suitability. The rules regarding conflicts of interest are extensive.
32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	The SC has plans in place for dealing with a firm's failure. The plans are flexible to include action to restrain conduct, to ensure clients' assets are properly managed and to provide relevant information to the regulators and the general public. There are investor compensation funds available in the event of losses. Where a failure has cross border implications, MOUs are in place to facilitate information sharing.
33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	Exchanges are subject to authorization by the Minister with the advice of the SC. An electronic facility, which falls within the meaning of "stock market" but is not intended to operate as a stock exchange or derivatives exchange, must be registered by the SC as a Registered Electronic Facility (REF). There are specified criteria that any applicant must meet, including requirements regarding systems and other infrastructure capacity, technical competence etc.
34. There should be on-going regulatory supervision of exchanges and trading systems that should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate	The SC has a comprehensive oversight system for exchange supervision that includes on-site examinations and off-site reviews of rules and other matters. The SC may suspend the operations of a stock exchange or REF. On the recommendation of the SC, the Minister may revoke the authorization of any exchange; the SC may revoke an REF's registration. Surveillance of the markets is carried on by the exchanges and SC.

<b>Principle</b>	<b>Findings</b>
balance between the demands of different market participants.	
35. Regulation should promote transparency of trading.	There is both pre-trade and post-trade real-time transparency of prices on the Bursa Malaysia exchanges for most trades, Certain specified trades (Direct Business Transactions) are permitted to take place outside the automatic trading system, subject to clearly defined conditions and prompt post-trade reporting. There are no dark pools operating in Malaysia.
36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	The rules against market abusive transactions are extensive and there are mechanisms in place to detect and take action against improper conduct. Both the SC and the Bursa collect and analyze extensive trading data to deter and detect improper transactions.
37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	Trades on both the securities and derivatives exchanges are cleared and settled through central clearing houses that have detailed and transparent provisions designed to protect the markets against a default by any participant. There are regular consultations and sharing of information between Bursa Malaysia and the SC. There are also both formal and informal arrangements in place to enable SC and BNM to consult each other in order to minimize the adverse effects of market disruptions.
38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	Not assessed

### **E. Summary Implementation and Recommended Action Plan**

**Table 6. Recommended Action Plan to Improve Implementation of the IOSCO Principles**

<b>Principle</b>	<b>Recommended Action</b>
Principle 1	The authorities should be encouraged to continue to work jointly to ensure consistency in the standards of disclosure and market conduct and in the supervision of the market participants, in order to provide Malaysian investors with an appropriate level of investor protection, regardless of which investment product or service they acquire or intermediary from which they acquire it.

Principle	Recommended Action
Principle 2	<p>The SCA should be amended to include general qualification requirements for Commission members, state that a Commission member may only be removed from his/her office for cause and delineate those causes, such as bankruptcy, persistent failure to attend meetings, acting in conflict of interest, etc. The right of the Minister to remove members at any time should be repealed.</p> <p>Consideration should be given to extending the statutory immunity provisions in the SCA to persons who were acting on behalf of the SC at the time of the actions in question. Coverage should not depend on the person's employment status at the time of the lawsuit; former employees and agents should be included.</p> <p>Further, consideration should be given to including provisions permitting the SC to indemnify these persons for their legal costs in the event they are sued.</p>
Principle 6	<p>As the SC has an explicit mandate and authority for monitoring, mitigating and managing systemic risk, consideration should be given to making the SC a permanent member of the Financial Stability Executive Committee.</p>
Principle 9	<p>The first regulatory audit of FIMM by the SC should take place as soon as practicable.</p> <p>(Note that the regulatory audit of FIMM was conducted by the SC in May 2012.)</p>
Principles 11 and 12	<p>Consideration should be given to conducting an examination of the adequacy (and the consistency) of maximum fines that may be imposed under the legislation to ensure these amounts are high enough, given the growth in the market and its profitability. In any event, the fines that can be imposed by the SC should not be less than those that may be imposed by the Bursa.</p>
Principle 16	<p>The SC's Corporate Governance Blueprint 2011 recommends a taskforce of industry and regulators to be formed to review the current framework for periodic disclosure of financial and non-financial information, including the shortening of the submission period for quarterly and annual reports. This should be pursued. In particular, consideration should be given to requiring the audited annual financial statements to be published within 90 days of the year-end, with the annual report available promptly thereafter.</p> <p>The SC should consider recommending the CMSA be amended to provide for civil liability for misstatements in continuous disclosure documents in the same way this liability applies to misstatements in prospectuses and other offering documents. Actions on these civil liability claims can be made simpler by including a provision that anyone who purchased the security affected by the misstatement is deemed to have relied on that misstatement.</p>
Principle 17	<p>The SC's Corporate Governance Blueprint contains recommendations that encourage:</p> <ul style="list-style-type: none"> <li>• Companies to voluntarily extend the notice period for shareholder meetings to ensure investors have sufficient time to make fully informed decisions about the matters to be discussed at a meeting and to return their voting instructions in time; and</li> <li>• The elimination of the restrictions in Section 149 of the Companies Act that limit who may be appointed as proxy and the actions the proxy may take.</li> </ul>

Principle	Recommended Action
	<p>These changes should be pursued to ensure all shareholders have the information in time to make informed voting decisions and can execute them effectively. The proxy limitations have been addressed in the Listing Requirements, however, consideration should be given to making these mandatory requirements for all public companies.</p> <p>Consideration should be given to aligning the requirements governing reporting interests in the securities of issuers held by substantial shareholders, officers and directors. The shorter time period that currently applies to the CEO and directors of listed companies under the CMSA should be applicable to all of the substantial shareholders, directors and all senior management of the issuers. The requirements should apply to all public companies. Consideration should be given to making this information for non-listed companies available to the public on the SC's website.</p> <p>Consideration should be given to widening the definition of what must be disclosed (by both substantial shareholders, directors and officers) to include public rights offerings that are presently excluded by the CMSA and the Companies Act.</p>
Principle 22	<p>The first inspection of a CRA should take place as soon as practicable. (Note that an on-site inspection of one of the two CRAs took place shortly after the FSAP assessment visit was completed.)</p>
Principle 30	<p>In the longer term, consideration might be given to re-examining the capital requirements for FMCs and moving to a risk-based formula that is more sensitive to the risks of the specific positions held.</p>
Principle 31	<p>The Malaysian regulatory framework requires a market intermediary to be subject to a periodic evaluation of its internal controls and risk management processes. The firm's internal auditor may conduct this review. Consideration should be given to requiring external auditors do these assessments, at least for the stock brokers and futures brokers that are members of Bursa Malaysia.</p>

### F. Authorities' Response to the Assessment

79. **The high level of compliance accorded to the Malaysian capital market in this assessment** under the more rigorous IOSCO standards and the new Financial Market Infrastructures (FMI) principles demonstrates that the strategic 'roadmap' adopted by the SC in regulating and developing the market has been appropriate.

80. **Since its establishment, SC has been committed to benchmarking itself against international standards and best practices.** In the past, prevailing market conditions led the SC to implement a prescribed approach to regulation which was appropriate and effective under the circumstances. The SC has instituted a comprehensive regulatory and supervisory framework, including the issuance of detailed laws and guidelines. This approach has effectively enabled the SC to heighten transparency and establish clarity on the roles and

responsibilities of market participants, thus promoting stability and confidence in the Malaysian capital market.

81. **These strategies were documented in the first Capital Market Masterplan (CMP1), and recommendations were implemented between 2001 and 2010.** These measures, including market developmental initiatives, fostered stability and resilience which helped to insulate the Malaysian capital market from the impact of the recent global financial crisis. There is now a strong foundation for on-going efforts to develop the capital market within a robust regulatory and supervisory structure, underpinned by a mandate to ensure investor protection and reduce systemic risk. The IOSCO assessment result, as well as the Malaysian capital market's successful weathering of the recent GFC, is a validation of the regulatory philosophy that is being adopted.

82. **The capital market has expanded significantly and become an important source of financing in the Malaysian economy, particularly with the development of the bond market to meet long-term financing needs.** The capital market continues to evolve in support of Malaysia's economic transformation agenda. The resilience of the market now gives SC the flexibility to adopt a regulatory framework that can drive greater competition and innovation. Under the CMP2, the SC will adopt a regulatory approach that will further drive market growth domestically and through greater internationalisation, while focusing on strong governance arrangements, and streamlining regulatory procedures and processes.

83. **Malaysia is taking continuous steps to align its regulatory framework with the changing global regulatory landscape and is actively involved in international financial regulatory policymaking work.**<sup>10</sup> Amid the growing regional expansion of local market intermediaries and plans to further internationalize the Malaysian capital market, the SC also recognises the increasing importance of cross-border enforcement and supervisory cooperation.

84. **While SC continuously reviews its policies to ensure that regulatory and supervisory requirements remain relevant and effective,** it welcomes suggestions by multilateral institutions like the IMF and the World Bank, and pro-actively learns from international best practices for putting in place appropriate preconditions that will be essential to ensure an effective regulatory regime.

85. **The SC notes that a number of recommendations in the IOSCO DAR reflect strategies identified in CMP2 as well as the CG Blueprint.** Consequently, the SC is already in the process of implementing the recommendations in this Report.

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<sup>10</sup> The SC Chairman is a member of the IOSCO Board and Vice-Chairman of the Emerging Markets Committee. The SC is also involved in several regulatory policy committees of IOSCO.

86. **This Report noted that, as a self-funding statutory body with comprehensive rules of internal governance, SC is operationally independent.** The Report also noted that, in practice, any discretionary power of the Minister provided by the securities law has always been exercised upon advice and recommendation by the SC. The ability of the SC to promote a sound and transparent capital market that supports economic growth has resulted in building market confidence. The SC works closely with other regulators to ensure financial stability while encouraging the development of new market segments and entry of new players to promote competition. The overall stability of the capital market, amidst rapid but orderly growth, has also meant that SC is trusted by the market and the government to perform its functions effectively within its current governance structure.

87. **Issues raised in this Report on further enhancing information disclosure practices by issuers and treatment of securities holders have already been identified in the CG Blueprint, published prior to this assessment.** Resolving these issues is a priority for the SC and is part of its on-going efforts to heighten the quality of corporate governance in Malaysia. These include the formation of a taskforce to review the current framework for periodic disclosure by issuers (including the need to shorten the submission period for quarterly and annual reports); a proposed extension of the notice period for shareholder meetings to ensure effective and informed investor participation; and the removal of restrictions on proxy voting. As of 3 January 2012, the Bursa Malaysia Listing Requirements no longer have qualification restrictions for proxies and allow shareholders of listed companies to appoint multiple proxies.

88. **The SC would like to thank the IOSCO assessors for their time and effort in engaging with the SC staff, other authorities, market institutions and intermediaries, and other stakeholders.** While the assessment required significant resources and time, it has been valuable in enabling the SC to identify its strengths as well as areas for further improvement. The IOSCO assessment methodology is a useful tool for reviewing of the effectiveness of regulatory and supervisory frameworks. The analysis and recommendations contained in this Report will feed into SC's on-going improvement efforts, with the aim of effectively supporting the projected growth and greater internationalization in the capital market during the CMP2 period.

#### IV. CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS (IADI)

##### A. Methodology Used for the Assessment

89. **The evaluation of the compliance with the Core Principles for Effective Deposit Insurance Systems was conducted on the Malaysia Deposit Insurance Corporation (Perbadanan Insurans Deposit Malaysia or PIDM) utilizing the Methodology for Compliance Assessment adopted in December 2010 by the Bank for International Settlements and the International Association of Deposit Insurers.**<sup>11</sup> The Assessment addresses PIDM's compliance with the Core Principles solely with respect to its operations as an insurer of deposits in commercial banks. In accordance with the Methodology, the Assessment is designed to assess to the extent possible whether the criteria are fulfilled in practice and not just in theory.

90. **The assessment was based on a review of relevant laws, regulations and regulatory and supervisory practices related to the conventional banking sector and the operations of PIDM.** PIDM is an operationally independent deposit insurance agency reporting to Parliament through the Minister of Finance. PIDM completed a self-assessment in preparation for the FSAP and conducted a Workshop using the Core Principles Methodology to assist in the FSAP review.

91. **There has been no experience with bank failures in Malaysia since PIDM's establishment in 2005.** As a result the Assessment looked at the relevant provisions of the legal framework without consideration of how the laws had been applied in practice or interpreted by the courts. Several weaknesses in the legal framework have been noted in this Assessment.

##### B. General Preconditions for an Effective Deposit Insurance System

###### Sound Governance of Agencies Comprising the Financial Safety Net

92. **BNM assumes responsibility for addressing financial stability concerns given its mandate, powers and responsibilities and its role as the central bank and supervisory authority for the banking and insurance sectors.** Within BNM there is a Financial Stability Committee which serves as BNM's internal forum for discussing risks to financial stability and deciding on the appropriate policy responses. It is at this Committee that a decision would be made as to the non-viability of an institution, including member institutions of PIDM.

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<sup>11</sup> This assessment was conducted by Claire McGuire, Senior Financial Sector Specialist with the World Bank.

93. **BNM also has a Financial Stability Executive Committee (FSEC) established in 2010 under Section 37 of its Act which considers proposals related to its various powers.**

These powers include the issuance of orders or provision of liquidity assistance to persons or financial institutions which it does not supervise, the purchase of shares or other capital instruments or businesses or assets of a financial institution or the vesting of the business, assets or liabilities of a financial institution in BNM, a corporation established by BNM or another financial institution or other person. Two executive members from BNM and four other members (Ministry of Finance, PIDM, an accountant and a lawyer) make up the FSEC. The private sector members of the FSEC are subject to a Code of Ethics and Conflict of Interest; they are also required to submit annual declarations of compliance with the Code and filings of assets and exposures.

94. **BNM is empowered to enter into arrangements with other supervisory authorities to coordinate financial stability measures.** BNM engages with the Securities Commission Malaysia and PIDM on a regular basis; the Governor of BNM sits on PIDM's Board. BNM coordinates with both agencies in the area of surveillance and supervision to facilitate the timely identification of pre-emptive responses to systemic risk.

### **C. Well-Developed Legal Framework**

95. **The legal system is well-developed with clear property rights.** The judiciary in Malaysia is independent, professional and benefits from protection of tenure and of an adequate remuneration system. The effective operation of the insolvency and creditor rights framework relies, to a large extent, on the intervention of the courts. The standing of the courts and judges has improved over the years, especially with the creation of commercial judges in Kuala Lumpur. As of a few years ago, there was a substantial backlog of bankruptcy and winding-up cases throughout the Malaysian court system. However, a new case management system has apparently significantly reduced the backlog of old cases as well as made the handling of new cases more efficient. There is general satisfaction with the quality of judges handling insolvency matters in Malaysia's major commercial centers, particularly in certain jurisdictions such as Kuala Lumpur where such matters are handled by judges in a specially established Commercial Court.

96. **Laws are in place under which the banking system and the deposit insurer can operate.** The legal structure in Malaysia supports the banking system and the deposit insurer although there is a need to develop a more modern insolvency regime for companies and individuals. There are at present a number of credit information providers, with a supervisor for the activities of all credit information systems, in line with best international practices.

97. **A legal framework exists for handling a bank failure that includes a method for effective failure resolution in a timely manner.** PIDM's and BNM's statutes provide for various methods by which a financial institution can be effectively resolved. The factors that

govern decisions on early intervention and non-viability should be made part of PIDM's statute.

98. **Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to a changing industry.** Both PIDM and BNM have had recent, extensive changes to their governing statutes. A significant effort is underway to amend the Banking and Financial Institutions Act of 1989 with a very advanced draft circulating for comment that BNM plans to table in the June Parliamentary session.

99. **Information exchange between the deposit insurance system participants and the supervisor is legally protected for all measures necessary in order to protect the deposits and to enable safety-net participants to intervene in case a bank is at risk.** All communications are subject to bank secrecy protections under Section 24 of the PIDM Act and PIDM and BNM have ongoing access to information on MIs.

100. **Appropriate participants in the financial safety net are entitled to protect depositors through a number of options including transferring deposits from a troubled bank to a healthy bank.** PIDM has the power to transfer deposits from a troubled bank to a Member Institution (MI) or other institution established for such purpose.

101. **Relevant authorities can take legal action against the management of a failing bank.** There is authority to take action against those responsible for a failing or failed bank both with PIDM (through a referral to the public prosecutor) and BNM. The public prosecutor also has the authority to take action if appropriate under the Penal Code and a liquidator may pursue a suit under the Companies Act if needed.

#### **D. Sound Accounting and Disclosure Regime**

102. **Accounting and disclosure regimes support the ability of the supervisor and deposit insurer to adequately evaluate the health of individual banks and the banking system as a whole.** Banking institutions in Malaysia are subject to Financial Reporting Standards (FRS) established by the Malaysian Accounting Standards Board which are in full compliance with the International Financial Reporting Standards (IFRS). Banking institutions are also subject to additional disclosure requirements established by BNM, including the Guidelines on Financial Reporting for Banking Institutions (requiring disclosures on deposits, loans, impairment provisions and remuneration) and Pillar II disclosure requirements under Basel II (risk management practices and the capital adequacy of banking institutions). Banking institutions listed on the local stock exchange are subject to additional disclosure requirements set forth by Bursa Malaysia Securities, the securities exchange. In addition, the majority of locally owned banking institutions and several of the foreign owned banking institutions with significant operations in Malaysia are rated by the domestic credit rating agencies.

103. **Accounting and disclosure regimes support the accurate and timely identification of information on depositor accounts for the purposes of prompt reimbursements.** PIDM is able to collect information on depositors directly from its MIs. PIDM also requires that MI's external auditors validate filings made with PIDM for the purposes of its Differential Premium System (DPS). There is also high level collaboration and co-ordination between the accounting profession and the regulatory reporting agencies.

104. **Accounting and disclosure regimes support the use of risk-adjusted differential premium systems adopted by the deposit insurer.** PIDM is able to validate its DPS both directly with its MIs and through validation by MIs' external auditors.

105. **The deposit insurer has the right to carry out or provide for an audit or inspection of a member bank in a timely manner if evidence shows that deposits may be at risk.** PIDM has special examination powers under Section 97 of its Act. Such an examination may include the examination of records, books, accounts or other documents and transactions of the MI.

#### **E. Main Findings**

106. **The deposit insurance framework in Malaysia, managed by PIDM, broadly conforms to best international practice.** PIDM was established in 2005 under the Malaysia Deposit Insurance Corporation Act (PIDM Act). PIDM administers a Deposit Insurance System (DIS) which covers deposits in conventional and Islamic banks as well as a takaful and insurance benefits protection system (TIPS) which insures policy owners and takaful certificate holders against the loss of part or all of their benefits in the event of a member institution failure. TIPS coverage was added to PIDM's mandate on December 31, 2010. Member institutions include all commercial banks, including locally incorporated foreign subsidiaries, Islamic banks licensed under the Islamic Banking Act of 1983, all insurance companies licensed under the 1996 Insurance Act except Danajamin Nasional Berhad and takaful operators registered under the 1984 Takaful Act (except international takaful operators). As of February 1, 2012, PIDM's membership consisted of 41 banks (25 commercial including 8 domestic and 16 Islamic banks) and 47 insurers (35 insurance companies and 12 takaful operators). The top five commercial banks make up over 60 percent of total insured deposits.

107. **PIDM is funded by annual premiums collected from member banks for both conventional and Islamic deposits, with TIPS funded by annual levies for takaful and insurance benefits.** The funds for conventional and Islamic deposits are separately administered with the Islamic deposit insurance fund administered in accordance with Shariah principles. PIDM administers an additional four funds (Family Solidarity Takaful Protection, Life Insurance Protection, General Takaful Protection and General Insurance Funds) for a total of six separate and distinct Funds. PIDM reports to Parliament through the Minister of Finance and is governed by a nine member Board of Directors, including two ex

officio members (the Governor of Bank Negara Malaysia and the Secretary General of Treasury, Ministry of Finance).

108. **Deposit insurance is compulsory for all deposit-taking conventional and Islamic banks.** PIDM protects all retail depositors, including corporate depositors, small businesses and individuals, up to the maximum of RM 250,000 per depositor per member institution. PIDM is legally mandated to reimburse depositors promptly, no later than 3 months after a winding up order. The current reserve level for conventional deposits is 0.14 percent of total insured deposits.

109. **PIDM has a number of strengths, including a culture of cooperation with other safety net players, strong performance in its exit from the Government Deposit Guarantee (GDG), a robust public awareness program, ongoing efforts at readiness and planning for potential financial institution resolutions and openness and transparency in its operations and reporting.** However, there are several areas for improvement, most importantly the need for MoF to execute a back-up funding agreement with PIDM and to limit MoF's legislatively-mandated involvement in the day-to-day operations of PIDM. A summary of the detailed assessment of compliance with the Core Principles is presented below.

#### F. Malaysia's Islamic Deposit Insurance System

110. **PIDM was established in 2005 as a dual deposit insurance system.** In addition to covering deposits in conventional banks, PIDM also covers eligible Islamic deposits (savings, current and investments accounts based on Shariah contracts including *wadiah*, *qard*, *mudharabah*, *murabahah* and *wakalah*). The Shariah compliant design is based on an arrangement of guarantee with fee or *kafalah bil ujr*. This system of insuring Islamic deposits was endorsed by the Shariah Advisory Council of Bank Negara Malaysia.

111. **The deposit insurance limit for Islamic deposits is at the same level as conventional deposits—RM 250,000—and the limit is separate from the limit for conventional deposits.** There is also separate coverage for trust accounts, joint accounts, professional practice, sole proprietorship and partnership accounts. Islamic and conventional banking businesses pay separate premiums and PIDM manages an Islamic Deposit Insurance Fund (IDIF) separately from its Fund for conventional deposits. Investments for the IDIF are made in Shariah-compliant instruments. Expenditures are charged to IDIF directly if attributable to Islamic member institutions and charged proportionately between Funds if the expenditures are not directly attributable.

112. **In 2010 PIDM's mandate was enlarged to protect takaful and insurance certificate owners in the event of an insurer member failure.** The takaful benefits protection system was also endorsed by the Shariah Advisory Council.

## G. Summary of Compliance and Recommended Actions

**Table 7. Summary of Compliance with the Deposit Insurance Core Principles**

Principle	Comments
1. Public Policy Objectives (PPOs)	PPOs are explicitly stated in the PIDM Act and are also regularly discussed in PIDM's Annual Reports and made part of its Corporate Plans, including the current Plan for 2012-2014.
2. Mitigating Moral Hazard	All appropriate design features are present in the PIDM framework. The PIDM has limited coverage in the amount of RM 250,000, an amount that covers 99% of depositors in the system but only 36.9% of total conventional and Islamic bank deposits held by member institutions. PIDM also has in place a Differential Premium System as authorized by Article 53 of its Act so that higher deposit insurance premiums are charged for banks that fall into higher risk categories.
3. Mandate	PIDM's mandate includes sound risk management as well as a role in the resolution process for non-viable banks. The preamble to its governing Act states that PIDM is empowered to implement promptly authorized resolution actions at minimum cost to the financial system. Article 4 of its Act also states that PIDM should, in achieving its PPOs, act in such manner as to minimize costs to the financial system. PIDM's powers are described in Sections 25 and 99 of its Act as including all powers as may be necessary for the furtherance of its objectives or the performance of its functions and duties.
4. Powers	PIDM has been given significant powers to operate in accordance with its mandate, including the powers needed to perform its resolution functions. PIDM also has early intervention powers under Section 25 of its Act.
5. Governance	Although there are no examples of any interference with PIDM's operational independence, there are a large number of approvals it must seek from MoF in performing its functions. These approvals present the possibility that PIDM's independence or effectiveness in meeting its mandate could be compromised or necessary actions could be delayed by the need to seek approval from MoF. These approvals are especially unnecessary given that the Secretary General of the Treasury is an ex-officio member of PIDM's Board. PIDM can only take the following actions with Minister of Finance approval: termination of membership (Section 39), setting annual premium rates (Section 48), assessing a premium surcharge against a member institution as a penalty for failing to comply with rules, regulations, its terms and conditions of membership or other requirements of PIDM or BNM (Sections 51, 153), making discretionary payments of insured deposits where a member institution is unable to make such payment for specified reasons (Section 57) and issuing rules, regulations or orders (Section 209).
6. Relationship with Other Safety Net Participants	There is a strong culture of cooperation between PIDM and other safety net players. PIDM and BNM work closely on major initiatives and share all relevant information on a regular basis, with PIDM having ongoing access to BNM's supervisory files. PIDM is a risk manager for its MIs and shares all its information with BNM. An appropriate national crisis management framework for managing a financial crisis should be established to include all safety net players.

Principle	Comments
7. Cross-border Issues	All foreign banks in Malaysia are licensed as subsidiaries and their deposits are covered by PIDM. BNM shares information with PIDM about cross-border banks that it obtains as a result of its formal and informal agreements and ongoing cooperation with relevant foreign home and host authorities. However PIDM should consider entering into agreements with deposit insurers in relevant jurisdictions for the purpose of resolution planning and exchange of deposit data and other information to facilitate resolution of a bank with cross-border operations.
8. Compulsory Membership	All commercial banks regulated by BNM are required to be members of PIDM. However, there are a number of financial institutions that take deposits from the public that are not part of the PIDM deposit insurance system. Several of these institutions are covered either by explicit or implicit Government guarantees but others (the credit cooperatives) are not covered by any insurance scheme. These cooperatives (with one exception) are not supervised by BNM but rather by the Malaysia Co-operative Societies Commission.
9. Coverage	The level of coverage is limited to RM 250,000 per insured account, an amount which covers almost 99% of depositors but only 36.9% of deposits held by MIs.
10. Transitioning from Blanket Guarantee	Malaysia successfully exited from a Government Deposit Guarantee (GDG) at the end of 2010 with careful planning and an effective communications strategy. At the same time as it exited from the GDG the law was amended with a substantial increase in deposit insurance coverage, from RM 60,000 to RM 250,000.
11. Funding	PIDM has established a Target Fund and has determined that it will reach that funding level in ten to twelve years. As a relatively new deposit insurer the current level of PIDM's reserves is small and may not be sufficient to handle the resolution costs of a medium-sized bank. For that reason it is even more critical that adequate liquidity funding be available. However, PIDM's statute provides only that MoF "may" lend money or provide funds to PIDM (Article 29 of the PIDM Act) and no funding agreement is in place that would make clear that such funding would be available when needed and under what conditions.
12. Public Awareness	PIDM has a comprehensive public awareness program and works closely with member institutions to make sure the public is aware of the existence and limits of coverage on their accounts. New deposit products must be submitted to PIDM for a determination of insurability.
13. Legal Protection	Under section 207 of the PIDM Act directors, officers and employees of PIDM as well as its subsidiaries and a bridge institution are granted immunity from suit for actions taken in good faith while discharging PIDM's mandate. Costs associated with any suit for current and former directors and employees would be covered by PIDM pursuant to a written policy.
14. Dealing with Parties at Fault	Relevant authorities have the power to seek legal redress against parties at fault in a bank failure.
15. Early Detection and Timely Intervention and Resolution	PIDM undertakes insurance and risk assessment to assess and monitor the risk inherent in providing deposit insurance. PIDM and BNM have developed early intervention and non-viability criteria as part of the Strategic Alliance Agreement (SAA). PIDM has developed an Intervention and Failure Resolution Framework (IFR) which sets forth its powers in responding to a failing MI. The SAA outlines the working arrangements between BNM and

Principle	Comments
	PIDM during the stages of planning for and undertaking an intervention and sets forth a PIDM Board approved Authority Matrix to define the roles of the two agencies (the Governor of BNM is an ex officio member of PIDM's Board).
16. Effective Resolution Processes	Once BNM issues a non-viability determination for a MI, PIDM has the power to resolve the institution using a variety of resolution tools, including the assumption of control of a MI, purchase and assumptions and bridge banks. PIDM must seek High Court approval for the appointment of a Receiver or a winding up order which may make these tools less effective in terms of providing certainty as to the timing of such actions by PIDM, although by assuming control under Section 99 of its Act the appointment of a receiver may not be critically time sensitive. The requirement that BNM declare an institution non-viable before PIDM can undertake resolution actions also presents the possibility that action will not be taken early enough to allow for effective use of all of PIDM's resolution tools especially given the absence of any definition of the term "non-viable" in the relevant legislation.
17. Reimbursing Depositors	Under Section 56 of its Act PIDM is obliged to make payments to depositors as soon as possible and not later than three months after a winding up order. Payments are computed as of the date of the filing of the petition for winding up (Section 59). PIDM has continuous access to information on its MIs and can require such institutions to provide it with depositor data on a priority basis if necessary. PIDM has the authority under Section 58 of its Act to make advance payments if necessary.
18. Recoveries	PIDM has control over the liquidation process under Sections 131 and 133 of its Act through its powers to direct the liquidator's actions. PIDM is a creditor of the failed bank's estate and is subrogated to the depositor's rights and interests on the deposit for any payments made to depositors. PIDM has developed an Asset Management and Disposition Policy which governs its actions when handling asset recovery.

**Table 8. Recommended Action Plan—Deposit Insurance Core Principles**

Principle	Recommended Action
5. Governance	The MoF should request that PIDM bring forward amendments to its enabling statute to remove those areas of approval that may interfere with its operational independence and effectiveness, such as approvals to set annual premium rates (Article 48), assess a premium surcharge (Article 51), issue rules and regulations (Article 209) and make discretionary payments of an insured deposit (Article 57) as well as the ability to disagree with PIDM on the termination of membership of a member institution (Article 39).
8. Compulsory Membership	A study should be undertaken to understand whether deposits at the DFIs and credit cooperatives qualify as deposits within the meaning of the terms “conventional deposit” or “Islamic deposit” under PIDM’s Act. To the extent that such institutions are deemed to be deposit taking, consideration should be given to the supervisory and regulatory framework under which those institutions operate that are not members of PIDM. Only those institutions that are subject to strong prudential regulation and supervision and are financially viable should be considered for membership in a deposit insurance system. The extent of coverage if any for depositors at any institution that is not part of the deposit insurance system should be made clear in communications to depositors at those institutions.
11. Funding	MoF should execute an agreement for back-up funding to make clear the obligation by the government to provide such funding if needed by PIDM to meet its mandate and to set out the process by which such funding should be requested and how it would be made available.
13. Legal Protection	PIDM should make coverage of former employees explicit in providing legal protection for protected acts done in the course of their employment.
16. Effective Resolution Processes	There is no statutory definition of non-viability. The criteria governing early intervention in a MI and for a determination of non-viability should be transparent and disclosed by amending PIDM’s statute.

## V. SUMMARY ASSESSMENT OF OBSERVANCE OF THE CPSS-IOSCO PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES

### A. Introduction

113. **The assessment of observance of the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI) for Malaysia was conducted in mid-2012.** The revised PFMIs were only adopted as an updated international standard in early 2012, and Malaysia is among the first jurisdictions to be assessed under the newly revised standard.<sup>12</sup>

### B. Institutional and Market Structure

114. **There is a clear demarcation of oversight, regulatory and supervision jurisdiction between the Securities Commission and the central bank.** The Bank Negara Malaysia (BNM), the central bank, is responsible for the oversight of the payment systems and settlement systems for unlisted government, BNM and private debt securities. The Securities Commission (SC) is responsible for the regulation, supervision and oversight of the FMIs for the corporate securities and derivatives markets.

115. **MyClear, a 100 percent owned subsidiary of the BNM, operates an integrated large value payment and securities settlement system—RENTAS.** RENTAS functions as a Real-Time Gross Settlement System (RTGS) which is integrated with a centralized securities depository (CSD) and also handles securities settlement of unlisted Government, BNM and private debt securities.

116. **The securities and derivatives clearing and settlement infrastructure is managed by the integrated exchange holding company Bursa Malaysia (BM).** BM is licensed as an exchange holding company and has a 100 percent owned subsidiary Bursa Malaysia Securities (BMS), a securities exchange, and a joint venture with the Chicago Mercantile Exchange (CME), Bursa Malaysia Derivatives (BMD), that is licensed as a derivatives exchange. Each of the exchanges has a central counterparty (CCP) for the respective market: Bursa Malaysia Securities Clearing (BMSC; wholly-owned by BM) for the securities market and Bursa Malaysia Derivative Clearing (BMDC; wholly-owned by BMD) for the derivatives market. The BM also has a 100 percent owned subsidiary BMDepo that functions as the lone CSD for the securities traded on the BMS.

117. **The BM had planned a default drill for its FMIs well before the FSAP assessment and this has been taken into account in the assessment however the actions taken by the FMIs and authorities subsequent to the FSAP while being acknowledged are not being taken into account in the assessment.** The default drill was proposed in

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<sup>12</sup> The assessor was Harish Natarajan of the World Bank and was supported by Isaku Endo (also World Bank).

January 2012 and was planned to be executed in December 2012. The assessors were notified of the successful conduct of this and also the plans to conduct this on a periodic basis. The principle 13 (default procedures) and principle 14 (segregation and portability) for the BMSC and the BMDC have been assessed taking this into account. A number of other initiatives have been taken post the FSAP assessment that could address specific gaps identified in the FSAP. These are acknowledged, but the assessment does not take these into account as part of the rating for the impacted principles and responsibilities. These initiatives include enhancement of stress testing scenarios and overall credit risk framework by the BMSC and BMDC; institution of liquidity risk management stress tests by the BMSC and the BMDC; and, the enhanced MOU entered into between the SC and the BNM and the establishment of a focus group to discuss co-operative oversight arrangements.

### C. Payments System and Bond Clearing and CSD

118. **The RENTAS system was assessed with the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI) as a unified system although, from a technical standpoint, it involves the operation of three FMIs.** The rationale of this choice was that the system is highly integrated. A few areas of further improvement are noted.

- **Legal Basis:** The legal framework explicitly provides for finality. However the certainty of protection of collateral placed for liquidity support and protection of repo arrangements is not explicit. This is not an immediate concern as all the participants that use these facilities are supervised by the BNM and the BNM is responsible for initiating insolvency/bankruptcy proceedings for these entities, however when other classes of entities are allowed this could be an area of concern.
- **Collateral:** The valuation of collateral placed for intra-day credit facility which could be converted to overnight credit is based on quotes from principal dealers. This could be enhanced by seeking quotes from the Bond Pricing Agency.
- **CSD:** The segregation arrangements for the customers that have been provided for in the legal framework should be tested and procedures for implementing portability should be tested.
- **Disclosure Framework:** The RENTAS is required to comply with the relevant CPSS-IOSCO standards with the introduction of the PFMI the RENTAS should comply with the disclosure requirements as well.

## D. Securities Clearing and CCP

### 119. The main findings for BMSC are:

- **Legal Basis:** The legal framework for the securities market explicitly provides for finality and protection for collateral but explicitly recognizes netting and novation only at the level of rules. An independent legal opinion has confirmed the enforceability of the rules; however as part of the proposed Financial Services Act these can be addressed at the level of law as well.
- **Credit Risk:** The stress testing models need to be enhanced and reviewed monthly against the current quarterly review schedule. The BMSC does not collect margins and the resources used for handling credit risk is the clearing guarantee fund, the SBL-CLA collateral for SBL-CLA related exposures and in addition the liquid assets of the BMSC. The size of the clearing guarantee fund should be enhanced to ensure that committed funds are adequate to handle the default of the participant with the largest exposure. Stress tests in 2011 indicated the committed funds would be just about sufficient, however after inclusion of the stand-by credit facility from the BM defaults of the three participants with the largest exposures could be handled.
- **Margin:** The BMSC has established a clearing guarantee fund that is pre-funded by the participants, the BMSC and the stand-by credit arrangement from the BM. This fund is structured to cover the potential exposure of the BMSC from the settlement default of the novated trades of a participant with the largest settlement position. The structure and the objective of the clearing fund do not fully conform to the margin methodology envisaged for the PFMI. The BMSC should consider instituting a margin mechanism, this can be done by recasting a part of the CGF as a margin which is collected based on the positions of the participants and also have the ability to collect variation margin on an intra-day basis.
- **Liquidity Risk:** The BMSC does not have an explicit stress testing model for assessing its liquidity risk. The BMSC should institute this and also subject it to periodic review.
- **Exchange of value:** The DVP mechanism is achieved by placing a system-wide freeze on the CSD until the funds leg is completed. However buy-ins initiated to address delivery failures can over-ride the freeze and there could be a scenario where a participant receiving securities as part of the days' settlement and participate in the buy-in using those securities even before his fund pay-in and potentially default on his funds obligation. This risk is however mitigated by the operational controls required to be instituted by the participants, which ensure that the participant's clients cannot participate in the buy-in process without them first

having met their settlement obligations for the day. The BMSC should ensure that the CSD systems prevent the above scenario from happening or alternatively ensure that the market participants exercise specific operational controls in their processes to prevent this from happening.

- **Default procedures:** At the time of the FSAP assessment the BMSC had proposed to carry out a default drill in December 2012 and on a periodic basis thereafter. The assessor was notified about the successful completion of the default drill as planned. The BMSC should ensure that the drill is carried out on an ongoing basis and also any gaps or issues identified are addressed in a time-bound manner.
- **Operational Reliability:** The BM manages the BCP at a group level and has a stated Recovery Time Objective (RTO) of 5.5 hours for critical function which includes depository, clearing and settlement arrangements. The BMSC does not fully test the reliability of the participants BCP procedures.

#### E. Central Securities Depository

120. **The operational reliability issue mentioned for the BMSC applies for the BMDepo as well.**

#### Derivatives Clearing and CCP

121. The main findings for BMDC are:

- **Legal Basis, default procedures and operational reliability:** The observations related to these principles summarized above for the BMSC are applicable to the BMDC as well.
- **Credit Risk:** The stress testing models need to be enhanced and reviewed monthly against the current quarterly review schedule.
- **Margin:** The Margin model is currently only reviewed twice a year it should be reviewed every month with a full-fledged review once a year.
- **Liquidity Risk:** The BMDC does not have an explicit stress testing model for assessing its liquidity risk. The BMDC should institute this and also subject it to periodic review.

#### Supervisory Oversight

- **Responsibility C:** The authorities currently do not have a formal mechanism for disclosing their oversight policies with respect to the FMI'S for the securities and derivatives market. The oversight policies for the payment systems are shared in

the annual financial stability report, however the extent of coverage could be enhanced and other delivery mechanisms could be considered.

- **Responsibility E:** The co-operative arrangements in place should be fully leveraged and the extent of information and scope of collaboration could be enhanced. Information sharing related to concentration limits in settlement banks and letter of credits could be enhanced. The scope of collaboration could be enhanced to jointly explore aspects related to FMIs on an ongoing basis.

## F. Key Recommendations for FMIs

**Table 9. FMI Recommendations—RENTAS (RTGS, CSD and SSS)**

Principle	Issue of concern and other gap or shortcoming	Recommended action and comments
13	Testing of default management procedures	MyClear should introduce periodic testing of the default management procedures and involve the participants also.
11	Articulate how the CSD would support the portability of client holdings.	MyClear could enhance their disclosures related to RENTAS and test their ability to support portability of client holdings.
23	Comply with the disclosure framework requirements.	All the FMIs should comply with the disclosure framework requirements as part of their ongoing compliance to the regulatory and oversight requirements.
1	The legal framework could be strengthened to provide explicit protection for the collateral placed for intra-day credit in the RENTAS and also for repo arrangements.	The provisions in the CMSA that provides for primacy of the default procedures of the BMSC and BMDC over any insolvency related proceedings could be replicated for the RENTAS as well perhaps in the PSA or in the upcoming Financial Services Act.
5	The valuation for the PDS accepted as collateral for the ICF should also include price information from the Bond Pricing Agency.	Currently the price quotes are collected from the principal dealers only. The reliability of the price estimates could be enhanced by taking quotes from the Bond Pricing Agency.
17	Enhancing the operational reliability through more robust verification of participants BCP.	RENTAS has a robust BCP; the operational reliability of the whole system can be enhanced by robust verification of the participants BCP arrangements for (e.g.) by requiring external certification of participants BCP. In addition exceptional scenarios like RENTAS experiencing operational issues close to end-of-business day, unusual queue sizes, and high number of requests for ICF etc. could be included in the BCP testing.

**Table 10. FMI Recommendations—BMDC**

Principle	Issue of concern and other gap or shortcoming	Recommended action and comments
7	There is no stress testing model used for monitoring liquidity risk.	The BMDC currently use the results of the credit risk stress to monitor liquidity risk. In addition to this they should create specific models for assessing liquidity risk, this could include for (e.g.) simulating unavailability of one or more banks with which they maintain their liquid assets.
13	Testing of default management procedures	The assessor was notified that the BMDC has conducted the planned default drill and also that this drill is planned to be conducted on a periodic basis. The BMDC should ensure this is incorporated as an ongoing activity and any gaps or issues identified are addressed in a time-bound manner.
14	Testing and validation of segregation and portability arrangements	The BMDC should verify and test its ability to assist movement of customers' positions from a defaulting participant to another. The assessor was notified that this was included in the default drill conducted in December 2012. The BMDC should ensure that this is included in future default drills as well and any gaps or issues identified are addressed in a time-bound manner.
23	Comply with the disclosure framework requirements.	All the FMIs should comply with the disclosure framework requirements as part of their ongoing compliance to the regulatory and oversight requirements.
1	The CMSA and the SCA do not explicitly recognize netting and novation. These are however addressed in the default procedures of the BMDC which have primacy in the event of insolvency of a participant.	The provisions in the PSA related to finality, netting and novation can be replicated for the BMSC and BMDC. This could be addressed as part of the upcoming Financial Services Act which envisages empowering the BNM to declare the BMSC and BMDC as designated payment systems.
17	Achieve RTO of less than two hours and be able to continue performing from DR site for prolonged period of time	The RTO of the BMDC is currently more than 2 hours. The BCP and all associated processes, systems and procedures should be structured to achieve this objective. In addition this should be periodically tested. The BMDC should also institute a robust process for ascertaining the effectiveness of the BCP of the liquidity providers, settlement banks and banks where it holds its and participants funds.
9	The settlement is currently in commercial bank money.	It is recommended that the BMSC and BMDC in a time-bound manner migrate settlement from commercial bank money to central money in the RENTAS. This would need the active involvement of the SC and the BNM.

**Table 11. FMI Recommendations—BMSC**

Principles	Issue of concern and other gap or shortcoming	Recommended action and comments
4	The stress testing methodology is inadequate and the size of the clearing guarantee fund is likely inadequate as well.	The stress testing of the BMSC should incorporate the SBL and BFF related credit risks as well and include more robust scenarios for (e.g.) stock specific movements. In addition the BMSC could consider the following to further strengthen the credit risk management framework: (i) stand-by credit of the BM should be converted into an explicit BM contribution to the CGF; (ii) evaluate the relevance of the BFF given its limited usage and encourage the participants to use credit facilities from the banks; and, (iii) on an ongoing basis enhance the stress testing process by including scenarios that cover other market factors, stock specific movements and forward looking scenarios and review them on a more frequent basis.
6	The BMSC CGF mechanism does not fully conform to the margin requirement of the PFMI.	An initial and variation margin mechanism should be instituted at the earliest. A portion of the participant's contribution to the CGF can be collected as margin. This component should be collected based on the participant specific risks and computed on a daily basis and also have the ability to collect on an intra-day basis.
7	There is no stress testing model used for monitoring liquidity risk.	The BMSC currently use the results of the credit risk stress to monitor liquidity risk. In addition to this they should create specific models for assessing liquidity risk, this could include for (e.g.) simulating unavailability of one or more banks with which they maintain their liquid assets in particular in periods of heightened liquidity stress and over multi-day periods
13	Testing of default management procedures	The assessor was notified that the BMSC has conducted the planned default drill and also that this drill is planned to be conducted on a periodic basis. The BMSC should ensure this is incorporated as an ongoing activity and any gaps or issues identified are addressed in a time-bound manner.
14	Testing and validation of segregation and portability arrangements	The BMSC should verify and test its ability to assist movement of customer's positions from a defaulting participant to another. The assessor was notified that this was included in the default drill conducted in December 2012. The BMSC should ensure that this is included in future default drills as well and any gaps or issues identified are addressed in a time-bound manner.
23	Comply with the disclosure framework requirements.	All the FMIs should comply with the disclosure framework requirements as part of their ongoing compliance to the regulatory and oversight requirements.
1	The CMSA and the SCA do not explicitly recognize netting and novation. These are however addressed in	The provisions in the PSA related to finality, netting and novation can be replicated for the BMSC and BMDC. This could be addressed as part of the upcoming Financial Services Act which envisages

<b>Principles</b>	<b>Issue of concern and other gap or shortcoming</b>	<b>Recommended action and comments</b>
	the default procedures which have primacy in the event of insolvency of a participant.	empowering the BNM to declare the BMSC and BMDC as designated payment systems.
12	The DVP arrangements need to be tightened.	DVP is currently achieved by placing a system-wide freeze on the BMDepo which is released only when the funds leg is completed. There is however an exception allowed for participating in a buy-in. A system check should be instituted to ensure that a participant receiving securities as part of the days' delivery cannot participate in the buy-in with those securities. Alternatively the BMSC could ensure that the operational controls that the market participants are required to enforce as per the BMS rules to prevent this from happening is indeed enforced on an ongoing basis.
17	Achieve RTO of less than two hours and be able to continue performing from DR site for prolonged period of time	The RTO of the BMSC is currently more than 2 hours. The BCP and all associated processes, systems and procedures should be structured to achieve this objective. In addition this should be periodically tested. The BMSC should also institute a robust process for ascertaining the effectiveness of the BCP of the liquidity providers, settlement banks and banks where it holds its and participants funds.
9	The settlement is currently in commercial bank money.	It is recommended that the BMSC and BMDC in a time-bound manner migrate settlement from commercial bank money to central money in the RENTAS. This would need the active involvement of the SC and the BNM.

**Table 12. FMI Recommendations—BMDepo**

<b>Principle</b>	<b>Issue of concern and other gap or shortcoming</b>	<b>Recommended action and comments</b>
11	Articulate how the CSD would support the portability of client holdings.	The BMDepo could enhance their disclosures and test their ability to support portability of client holdings.
17	Achieve RTO of less than two hours and be able to continue performing from DR site for prolonged period of time	The RTO of the BMDepo is currently more than 2 hours. The BCP and all associated processes, systems and procedures should be structured to achieve this objective. In addition this should be periodically tested.
23	Comply with the disclosure framework requirements.	All the FMIs should comply with the disclosure framework requirements as part of their ongoing compliance to the regulatory and oversight requirements.

**Table 13. FMI Recommendations—Authorities**

Responsibility	Issue of concern and other gap or shortcoming	Recommended action and comments
Responsibility C	Disclosure of Oversight policies	The SC and the BNM could enhance their disclosure of oversight policies to the public. The disclosure to the FMIs is adequate.
Responsibility E	Co-operation arrangements	The co-operation framework is in place; however, the SC and the BNM should operationalize the co-operation in the area of oversight of the FMIs by expanding the scope of information exchange on an ongoing basis and initiating joint efforts to enhance safety, efficiency and reliability for the payment and settlement systems. The BNM and the SC can consider leveraging the new MOU framework to enhance the operational co-ordination. These could include areas like sharing information relating to the ongoing oversight assessments of the FMIs in their respective jurisdictions and measures to enhance the risk management framework in the FMIs in their respective jurisdiction by sharing information that could be pertinent to the overseer of a particular FMI.

### G. Authorities' Response to the Assessment

122. **BNM and SC would like to thank the FSAP mission team for the substantive discussions, comprehensive assessment and recommendations in relation to the recently issued Principles for Financial Market Infrastructures (FMI) assessment.** The high level of observance accorded to RENTAS, BMSC, BMDC and BMDepo in this assessment under the more stringent FMI principles demonstrates that the strategic “roadmap” and the oversight approach adopted by the both BNM and SC in regulating these infrastructures have been effective. Given the robust payment and settlement framework already in place, BNM and SC have been able to fully implement many of the recommendations made by assessors, while others are in the midst of being implemented.

123. **Malaysia has been committed to continuously benchmarking itself against international standards and best practices.** In the case of the capital market, in 2008, we voluntarily underwent an independent assessment to benchmark our compliance with the

IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles), and this included our assessment on compliance with CPSS-IOSCO Recommendations for Securities Settlement Systems (SSS).

124. **The FMI assessment was a particularly challenging one to undertake.** In relation to the capital market, we had initially used the CPSS-IOSCO Recommendations for SSS and Central Counterparties (CCP), and its related methodology, to conduct the self-assessment of payment, clearing and settlement assessments; the FMI principles had not been officially released at the time of the self-assessment, and the FMI methodology was not finalized and still in the process of international consultation. Nevertheless, we were subsequently persuaded by the FSAP team to use the new standards and methodology. The FSAP mission provided a “patch” with which we conducted a further round of self-assessment to bridge any gaps between the CPSS-IOSCO recommendations and the FMI principles. During the assessment discussions, however, the guiding documents were the new FMI principles and the accompanying methodology, resulting in ratings being based entirely on strict application of the new methodology. Given the absence of a “track record” of assessments under the new FMI principles, we were disadvantaged by the inability to exercise flexibility and apply the principles to circumstances peculiar to Malaysia.

125. **An important issue for the capital market is that while we have been assessed by global standards, application of the methodology must be done within the context of the structure and characteristics of the domestic financial sector.** In the case of the FMI, the evaluation of systems, processes etc in place must take cognisance of the structure of the Malaysian financial sector. This also requires that the assessment must give sufficient weight to the outcome achieved, even if the implementation of a particular principle does not match exactly the approach described by the methodology, especially when such an outcome sufficiently contributes to the effectiveness and soundness of the payments and settlement systems.

126. **For example, stress testing should be commensurate with the risks in the Malaysian capital markets.** While we do not disagree with the view that there is a need to build scenarios for stress-testing that incorporates extreme possibilities, the assessment should give due recognition to regulatory equivalence, namely the features of the country financial sector and existing frameworks which act to build regulatory strength and reinforce each other in a manner expected of that particular principle. Risks scenarios must be appropriate, and avoid detrimentally-high costs of capital and operations. Good regulatory practice requires that measures are proportionate to the specific needs of financial system being assessed, and should minimise the risk of inefficiencies and loss of competitive position due to a high burden of regulation.

127. **Therefore, an important lesson from the capital market’s experience of the FMI assessment is that assessors should consider giving due recognition to the outcomes of measures and not just the measures in place.** The methodology does give options to

regulators on the means to achieve the results intended to be measured by the FMI standard. Given that there are likely to be many ways of achieving the expected outcome, the assessment would provide even more value, and lead to recommendations that are more meaningful to regulators and policy makers, if greater attention is given to actual results of measures.

128. **The SC and BNM work closely together to ensure financial stability and this has significantly helped to build market confidence and manage systemic risks issues.** In the case of FMI, the SC and BNM continuously engage, share information and co-operate very closely and undertake pre-emptive interventions where necessary. The regulatory framework in Malaysia is underpinned by a structure and practice of coordination between SC and BNM at various levels on operations and policy. The effectiveness of such close collaboration has been tested and demonstrated in avoidance of defaults and early management of problem issues.

129. **There are several principles assessed that we view as not taking into account the contextual considerations.** These include:

- *The issue of Bridging Finance Facility (BFF) not included by BMSC in its stress testing* -- taking the contextual argument, assessors need to give weight to outcomes, that the utilisation rate of the facility is very insignificant and that the PO's financial standing is relatively strong. Moreover, Bursa Malaysia has intention to remove the BFF.
- *Scenarios for assessing robustness stress testing in relation to the capital markets* – the scenarios for stress testing should take into account other market factors, adverse movement in more than one product and other forward looking stress scenarios. The stress testing scenarios should be proportionate to risks in the Malaysian capital markets. The 5 additional scenarios for stress test undertaken soon after being informed by assessors showed results that such additional factors did not post a significant loss to the Clearing Fund and the financial resources remain adequate. This again begets the point that outcomes should matter. The fact that we can quickly implement a shortcoming almost immediately after it being pointed out by assessors, indicate the robustness of the risk framework. Due weight should be given to the underlying framework and the results of the test, not just when the additional scenarios were tested.
- *Requirement for margins in the securities trading.* The principle on margin requirements for securities markets was first assessed as “not applicable” for the clearing of securities at the first round of assessment in July 2012. However, post peer review, the pendulum was swung to the other extreme, whereby this principle was not only reclassified as applicable to the securities clearing but rated as “not observed”. Such a rating implies that the BMSC allows its Trading Clearing Participants (TCPs)

to trade and clear their trades without any form of collateral or protection against potential TCP default, that trades on the Malaysian securities market are cleared by BMSC without any safety net. On the contrary, Malaysia has put in place a collateral system proven to be as effective as the margin requirements. While there is an alternative system in place that may not meet all the requirements of a margin system, credit must be given to the existence of such a system of pooled collateral that broadly achieves the intended results and objectives of a margin system. Further this alternative system of clearing and settlement is recognised in the FMI principle.

## Going Forward

130. **The SC's efforts to enhance the efficiency of the trading, clearing and settlement infrastructure have been articulated in both CMP1 (2001-2010) and CMP2 (2011-2020).** In CMP1, we recognised that an efficient trading, clearing and settlement infrastructure helps make more instruments accessible to larger pools of liquidity at minimal cost. Therefore on-going benchmarking of the trading, clearing and settlement standards and processes against international best practices remain a key priority, particularly where there is a need to further enhance the market infrastructure and regulatory framework.

131. **In CMP2, we recognised that, although the trading infrastructure for equities, derivatives and bonds has already been enhanced to improve market access and connectivity, given the changing intermediation landscape, market participants require a further reduction in friction costs and a seamless post-trade infrastructure for clearing and settlement.** Areas identified under CMP2 include enhancing post-trade settlement efficiencies through the implementation of straight through processing capabilities. This will involve identifying required improvements in clearing and settlement, depository, custody and collateral management practices, and the requirements to facilitate integration of clearing and settlement with the payments system. Integration of the money market and exchange-traded settlement systems will offer major benefits and help reduce settlement risk by introducing finality and certainty to payments. Other areas to be addressed include reducing the gap on the delivery-versus-payment arrangements and strengthening the process for failed trades.

132. **We will take on board recommendations to improve efficiency for a seamless post trade infrastructure for clearing and settlement.** We are revamping our Guidance on the Regulatory Role of Bursa Malaysia this year, and in line with FMI standards will introduce specific requirements and obligations on the clearing, settlement and depository services provided by Bursa Malaysia, such as enhancements to credit and liquidity risk management, strengthening collateral management practices and improving information sharing, supervision and surveillance of the clearing and settlement activities with a view to better monitor, mitigate and manage systemic risk to the financial sector.