MALAYSIA’S EXPERIENCE ON REGULATORY AND SUPERVISORY OVERSIGHT

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Malaysia’s Experience on Regulatory and Supervisory Oversight

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Outline

- Financial sector trends and developments in Malaysia
- Implications for regulatory & supervisory approach
- Key elements of current regulatory and supervisory framework
  - Supporting infrastructure
  - Macro and micro-surveillance
  - Crisis management
  - Financial capability
  - Supervisory coordination and cooperation
Financial system stronger since Asian financial crisis

Holistic approach addressed immediate needs, while strengthening foundation for long term stability

Institutional arrangements established to stabilise banking industry

- Danaharta removed NPLs from banking system, Danamodal facilitated recapitalisation of affected banks & CDRC facilitated voluntary debt work-outs for corporates
- All three been wound up
- Total cost at < 5% of GDP

Prudential framework strengthened

- Prudential limits and provisioning policies tightened
- Corporate governance strengthened
- Increased focus on risk management
- Improved surveillance mechanisms & financial transparency

Structural elements also strengthened

- Merger exercise to consolidate fragmented banking sector
  - 71 institutions consolidated into 10 banking groups
  - Capital size increased from USD2m - 3b to USD0.5b – 4b
- Capital market intermediaries rationalised
Successful restructuring enabled Malaysia to focus on medium and long term development

- Strengthened legal, regulatory and supervisory framework for financial institutions
- Emphasis on capacity building measures
- Diversification of financing structure with enhanced role for bond and equity markets
- Financing new growth areas e.g. DFIs, venture capital, agriculture insurance

**Financial Sector Master Plan**

- **Phase 1**
  Strengthen domestic capacity, and develop strategic and nascent sectors

- **Phase 2**
  Intensify competitive pressure in the domestic market and gradually liberalise market access

- **Phase 3**
  Assimilate into global market. Introduce new foreign competition. Enhance international positioning in areas of competitive advantage

**Capital Market Master Plan**

- 2001 - 2003
- 2004 - 2005
- 2006 - 2007
- 2010
Broad-based financial system in place...
...supported by a well-developed bond market

Malaysia’s position
(Size of Bond Market in % GDP)

- In terms of relative size to GDP, Malaysia ranked second after Japan
- Total bonds outstanding increased at average annual rate of 12.2% since 1998, underpinned by steady y-o-y increase in bond issuances
- Initiatives to develop bond market has improved liquidity, diversified product base, issuers and investors, enhanced price discovery and supporting infrastructure
- Private > public sector bonds with increasing sukuk issuances
  - PDS outstanding increased from 24.0% of GDP at end 1997 to 37.5% now
  - sukuk: 62.2% of total PDS
- Financing raised through bond market (including public finance) accounts for 40.8% of total financing (pre-crisis: 31.7%)

Source: Asian Bonds online, Sep 2007
# Current trends shaping financial landscape

<table>
<thead>
<tr>
<th>Category</th>
<th>Trends</th>
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</thead>
<tbody>
<tr>
<td><strong>Global financial integration</strong></td>
<td>• Growing volume of cross-border capital flows&lt;br&gt;• Increased activities of foreign banks in national markets&lt;br&gt;• Greater regional presence by domestic banks</td>
</tr>
<tr>
<td><strong>Growing importance of market-based finance</strong></td>
<td>• Increasing volume of financing raised through capital markets than banks&lt;br&gt;• Banks, in turn, have shifted towards more treasury-based activities</td>
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<tr>
<td><strong>Financial innovations</strong></td>
<td>• Rapid growth of financial products, services and channels&lt;br&gt;• Significant growth of derivatives&lt;br&gt;• Growing significance of Islamic finance</td>
</tr>
<tr>
<td><strong>Deregulation &amp; liberalisation</strong></td>
<td>• Financial conglomeration &amp; consolidation&lt;br&gt;• Larger and more complex financial institutions&lt;br&gt;• New business models</td>
</tr>
</tbody>
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... with implications for financial regulation

- Enhancing role of market discipline
- Attaining cross-sector & cross-border consistency
- Aligning prudential regulations with integrated risk management approaches
- More rigorous monitoring & control of systemic risk
- More effective coordination & information exchange
- Reducing excessive cost of regulation in segmented & overlapping jurisdictions
Shift in regulatory approach to adapt to changing market realities...

Explicit and narrow operating boundaries

• Highly prescriptive rules & regulations
• One-size fits all regime
• Compliance-focused and silo approach to supervision

Broader & less rigid environment

• Greater responsibility on institutions to manage risk exposures
• Principle-based & differentiated regulation & supervision
• Strengthened safeguards to contain systemic risk
• Greater reliance on market discipline
• Consultative approach in formulation of prudential policies
Ensuring consistent prudential framework, sound supporting infrastructure and organisational alignment
Realignment of regulatory and supervisory functions

- Sectoral to functional organisation
- More comprehensive view & cohesive approach to development of financial system
- Ensure clear distinction between prudential regulation & developmental objectives
- Sharpen focus on risk management with greater consistency in management of similar risks
- Reduce overlaps & duplication
- Enable more efficient use of regulatory resources
Alignment of legal and prudential framework

**Legislation**

- Ensuring sound legal basis for evolving prudential regulations in new risk areas
- More responsive legal framework aligned with principles-based regulatory approach
- Expanded enforcement & supervisory intervention powers
- Strengthened provisions on market conduct
- Greater cross-sector consistency

**Prudential framework**

- Implementation of Basel II (2008 for SA and 2010 for IRB)
- Strengthened supervisory expectations regarding corporate governance, risk management and internal controls
- More robust financial reporting & disclosure standards to reinforce market-based discipline
- Strengthened AML/CFT regime
- Rationalisation of prudential limits to address similar risks in consistent manner
- More differentiated regulatory regime which reinforces incentives for sound risk management
- Framework on consolidated supervision
Continuing focus on financial sector development...with appropriate sequencing of regulatory measures

Thrust of regulatory measures

- Ensuring sufficiently developed preconditions for financial stability *before* dismantling regulatory and supervisory constraints to contain excessive risk taking by institutions.

Advanced

Institutional & market development

Progressive liberalisation to enhance competitiveness

Regulatory system

Building and maintaining sound prudential foundation

Developing

Industry

Advanced
...as well as development of Islamic finance as viable alternative to support growth

Holistic approach to development of Islamic finance

**Develop infrastructure**
- Increase number and diversity of domestic & foreign players to stimulate competition
- Develop and deepen money, capital & equity markets
- Build intellectual and human capital
- Islamic deposit insurance

**Develop legal & regulatory framework**
- Strengthen Shariah framework
- Establish effective legal structure
- Enhance risk management
- Setting international standards through Islamic Financial Services Board (IFSB)
Managing policy trade-offs remains a challenge...

- Innovation & efficiency
- Competition
- Improved consumer outcomes

Market-based discipline

Financial regulation

- Balanced growth
- Strong domestic institutions
- Inclusive financial participation
Surveillance is more forward looking...

Current Effort
To determine the strength and identify emerging vulnerabilities

Ongoing trend analysis

EX-POST
Going forward
EX-ANTE

Determining current resilience/stress level
- To assess and quantify the resilience of the banking system at a point in time

Stress index
- To describe the stress levels of banking system in a single measure

Future Crisis/Stress Level Prediction
- To identify possibility of a crisis occurring within a specified timeframe

Stress Index
- To forecast potential stress level for the next period

Stress Test
- To assess capacity of industry/institutions to withstand potential adverse movements

EX-POST
Going forward
EX-ANTE
...supported by more dynamic and integrated macro and micro surveillance

**Financial System Risks**
- Identify emerging risks and transmission channels
- Understanding and monitoring linkages
- Assess contagion and systemic impact
- Payment system oversight

Enable comprehensive coverage and assessment of risks

Ensure optimal and efficient allocation of resources

**Financial Institution Risks**
- Minimize potential risks and vulnerabilities and subsequent contagion

Mutually reinforcing

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CENTRAL BANK OF MALAYSIA
Approach to supervisory risk assessment

1. Significant activities

2. Inherent Risks
   - Credit
   - Market
   - Operational
   - Liquidity
   - Insurance
   - Legal & Regulatory
   - Rate of return (for Islamic finance)
   - Equity investment (for Islamic finance)

3. Quality of Risk Management & Oversight
   - Static analytical tools
     - Trend analysis
     - Quantitative financial soundness indicators
   - Supervisory framework
     - Risk based & consolidated supervisory framework
     - Timely intervention
   - Forward-looking tools
     - Stress testing
     - Early warning system

4. Overall Net Risks
   - Capital & Earnings

5. Overall Composite Risk & Direction for risk over 12-mth horizon

6. Reporting & Intervention
Strengthened internal governance structure and process

**System level**

- Publication of Financial Stability & Payment System Report

**Institutional level**

- Financial Stability & Policy Committee
  - Financial Surveillance Technical Group
  - Supervisory Intervention Working Group
  - Rating panel

**Review**

- Assessment of emerging risks and determine appropriate policy interventions

- Technical deliberation of emerging risks & vulnerabilities to financial & payments system

**Determine appropriate supervisory intervention**

- Monitor problem institutions and evaluate intervention options

- Peer review process to ensure consistency in assessments and validate supervisory judgments
Building supervisory capacity is a key priority

- Competency assessments to ensure right talent at right place
- Development of specialists
- Improvements to performance-management system
- Investments in learning infrastructure and systems
- ICT enhancements
More robust crisis management with strengthened safety net...

- Malaysian Deposit Insurance Corporation established in August 2005
  - Explicit guarantee to depositors: RM60,000 per depositor per member institution
  - Dual and equivalent protection for Islamic and conventional deposits
  - Backed by least-cost resolution powers retained from Danaharta Act
  - Differential risk-based premium systems to reinforce sound risk management

- Ongoing initiatives to put in place a comprehensive and integrated crisis management (CM) framework
  - CM Team, communication, business continuity plan
  - At regional level, arrangements for CM under the EMEAP Monetary & Financial Stability Committee (MFSC)
More effective supervisory coordination and cooperation
...to ensure cross-sector consistency, enhance surveillance and support Basel II implementation

- MOUs with domestic (SC, PIDM) and foreign supervisory authorities
  - Surveillance
  - Policy consultation
  - Coordination of regulatory and supervisory processes

- Ensuring efficient and effective implementation of Basel II
  - Establishing reliance on home/host review/approval processes
  - Facilitating functionality and scale for internal models by promoting greater consistency in treatment between supervisors (e.g. treatment of Pillar 2 risks and diversification benefits)
  - Minimising regulatory costs associated with different implementation timing in different jurisdictions
Building financial capability to reinforce market discipline and pre-empt risk

- Consumer activism to reinforce market discipline
  - Enhance level & quality of service
  - More informed decisions
  - Ensure efficient financial intermediation

- BankingInfo and InsuranceInfo
  - Information booklets
  - Comparative Tables

- Credit Counseling and Debt Management Agency
  - Facilitate debt restructuring
  - Provide advice on financial and money management
  - Complement consumer education efforts
Today, significantly stronger and more competitive financial sector promotes continued financial stability and sustainable economic growth

- Key financial indicators strengthened across the board
- Nine domestic banking groups with strong capitalisation
- More effective and competitive in meeting economic needs
  - Wide array of products and services
  - Large presence of world class foreign banks (30% market share of assets)
- Robust risk management practices and infrastructure
  - Supported by stronger credit culture and governance structure
  - Centralised Credit Reference Information System (CCRIS)
- Strong growth & enhanced contribution of financial sector to economy

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<th></th>
<th>1997/98</th>
<th>Sept. ’07</th>
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<tbody>
<tr>
<td>RWCR</td>
<td>10.5%</td>
<td>13.1%</td>
</tr>
<tr>
<td>Net NPL Ratio</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3-month classification</td>
<td>13.2%</td>
<td>3.5%</td>
</tr>
<tr>
<td>ROA</td>
<td>-0.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>ROE</td>
<td>-4.5%</td>
<td>18.7%</td>
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<tr>
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<th>2001–06</th>
<th>Jan–Sep 2007</th>
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<tr>
<td>Growth in finance &amp; insurance services</td>
<td>6.9%</td>
<td>11%</td>
</tr>
<tr>
<td>Share of GDP</td>
<td>9.2%</td>
<td>10.2%</td>
</tr>
</tbody>
</table>
Thank You
Useful links

- Bank Negara Malaysia (http://www.bnm.gov.my)

- Malaysian Deposit Insurance Corporation
  - http://www.pidm.gov.my

- Bankinginfo and Insuranceinfo

- Credit Counselling and Debt Management Agency
  - http://www.akpk.org.my

- Centres for education and development
  - http://www.iclif.org
  - http://www.inceif.org

- Other regulators
  - http://www.sc.com.my
  - http://www.lofsa.gov.my