



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Licensing Framework for Digital Banks

Exposure Draft

Applicable to:

1. Applicants under section 10 FSA
2. Applicants under section 10 IFSA
3. Licensed digital banks
4. Licensed Islamic digital banks
5. Shareholders of proposed licensed digital banks

This exposure draft sets out the proposed framework to allow entry of digital banks with innovative business models that seeks to serve the underserved and unserved market segments. This framework forms part of a series of measures adopted by the Bank to enable innovative application of technology in the financial sector.

The Bank invites written feedback on this exposure draft, including areas to be clarified or elaborated further or alternative proposals that the Bank should consider. The written feedback should be supported with clear rationale and accompanying evidence or illustrations as appropriate to facilitate the Bank's assessment.

All feedback on the Exposure Draft should be submitted to the Bank by **28 February 2020** to the email or address below (electronic submission is encouraged). The Bank will assess all feedback received and aims to finalise the Policy Document by the first half of 2020. Applications for licence will be open upon issuance of the Policy Document.

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PART A OVERVIEW

1 Introduction

- 1.1 Technology-based innovations have proliferated within the financial sector, enhancing its service and delivering efficiency gains and ultimately contributing to the development of the broader economy. To support these developments, Bank Negara Malaysia (the Bank) has issued a series of enabling regulations including the Regulatory Sandbox, regulations on the use of cloud and electronic Know-Your-Customer, as well as participated in industry collaborations to test use cases for distributed ledger technology and develop Open API specifications.
- 1.2 In line with these efforts, the Bank has developed a framework for *digital banks* to offer banking products and services to underserved or unserved market primarily through digital or electronic means. Licensing of these new players with innovative business models is expected to add dynamism to the banking landscape to serve the economy and contribute to individual well-being. This includes expanding meaningful access to and responsible usage of suitable and affordable financial solutions for the underserved and unserved market segments.
- 1.3 The Bank is cognizant that such digital banks have not operated in a full financial and economic cycle. This calls for a balanced approach that enables admission of digital banks with strong value propositions whilst safeguarding the integrity and stability of the financial system as well as depositors' interest.
- 1.4 The proposed licensing framework for digital banks aims to achieve these outcomes through the application of a defined asset threshold in the initial three to five years of operations of a licensed digital bank. This functions as a 'foundational phase' for the licensees to demonstrate their viability and sound operations, and for the Bank to observe performance and attendant risks. During this phase, the licensed digital bank will be subject to a more simplified regulatory requirement.
- 1.5 The Exposure Draft provides for requirements on applications for the establishment of a digital bank, as follows –

- (a) Part B describes the eligibility requirement and application procedures that must be complied with by an applicant intending to carry on digital banking business or Islamic digital banking business. This is in addition to the application and assessment process set out in the policy document on *Application Procedures for New Licences under Financial Services Act 2013 and Islamic Financial Services Act 2013 (Licensing Procedures)*;
 - (b) Part C explains the business limitations and regulatory framework applicable to a licensed digital bank during the foundational phase; and
 - (c) Part D explains the business activities that must be undertaken and the physical access points that may be established by the licensed digital bank.
- 1.6 Licensed banks and licensed Islamic banks may apply for a digital bank licence separate from their current licensed entity should they wish to carry on digital banking business or Islamic digital banking business in a joint venture with other parties. However, this does not preclude licensed banks and licensed Islamic banks from digitalising their current business operations, which remains within the scope of their existing banking licence and does not require the application of a separate digital bank licence.

2 Applicability

- 2.1 This policy document is applicable to –
- (a) an applicant applying for a licence under section 10 of the FSA or section 10 of the IFSA to carry on digital banking business or Islamic digital banking business, as the case may be;
 - (b) licensed digital banks as defined in paragraph 5.2 of this policy document; and
 - (c) the shareholders who require an approval under section 90 of the FSA or section 102 of the IFSA for the holding of interest in the shares of the proposed licensed digital bank.

3 Legal provisions

- 3.1 The requirements in this policy document are specified pursuant to –
- (a) sections 9, 25(1), 47(1), 123(1) and 143 of the FSA; and
 - (b) sections 9, 22(1), 57(1), 135(1) and 155 of the IFSA.

- 3.2 The guidance in this policy document is issued pursuant to section 266 of the FSA and section 277 of the IFSA.

4 Effective date

- 4.1 This policy document comes into effect on the issuance of the final policy document.

5 Interpretation

- 5.1 The terms and expressions used in this policy document shall have the same meanings assigned to them in the FSA and IFSA, as the case may be, unless otherwise defined in this policy document.

- 5.2 For the purpose of this policy document –

“**S**” denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretative, supplement and transitional provisions that must be complied with. Non-compliance may result in enforcement action;

“**G**” denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted;

“**digital banking business**” means a banking business as defined in section 2(1) of the FSA which is carried on primarily or wholly through digital or electronic means;

“**Islamic digital banking business**” means an Islamic banking business as defined in section 2(1) of the IFSA which is carried on primarily or wholly through digital or electronic means;

“**licensed digital bank**” means –

- (a) a person licensed under section 10 of the FSA to carry on digital banking business; and
- (b) a person licensed under section 10 of the IFSA to carry on Islamic digital banking business.

6 Related legal instruments and policy documents

- 6.1 This policy document must be read together with other relevant legal instruments and policy documents that have been issued by the Bank. In particular –
- (a) *Licensing Procedures;*
 - (b) *Application Procedures for Acquisition of Interest in Shares and to be a Financial Holding Company (Acquisition Procedures);*
 - (c) *Approach to Regulating and Supervising Financial Groups; and*
 - (d) *Outsourcing.*

PART B ELIGIBILITY AND ADDITIONAL APPLICATION PROCEDURES

7 Factors for consideration in assessing the best interest of Malaysia criteria

- G** 7.1 In assessing an application to carry on a digital banking business or Islamic digital banking business, the Bank will have regard to part B of the *Licensing Procedures*.
- S** 7.2 In assessing the best interest of Malaysia criteria as specified under Schedule 5 of FSA or IFSA, an applicant is required to demonstrate to the Bank's satisfaction a commitment in driving financial inclusion, including ensuring quality access and responsible usage of financial services, particularly to underserved and hard-to-reach segments that may be unserved, which includes retail as well as micro, small and medium enterprises (MSMEs), in a sustainable manner, without jeopardising the interest of depositors.
- G** 7.3 To reflect the commitment to meet the best interest of Malaysia criteria, the shareholders of a licensed digital bank may offer an enforceable undertaking pursuant to section 259 of the FSA or section 270 of the IFSA. Similar commitments may also be incorporated as part of the licensing conditions of the licensed digital bank.

8 Factors for consideration in assessing shareholders

- G** 8.1 In assessing the suitability of the shareholders of the proposed licensed digital bank, the Bank will have regard to factors set out in paragraph 7.9 of the *Acquisition Procedures*.
- G** 8.2 Without limiting the generality of paragraph 8.1, the Bank may have regard to the ability of the applicant and where relevant, other shareholders collectively, to contribute to the proposed licensed digital bank in the following areas –
- (a) robust risk management and compliance capabilities, which may be demonstrated by a track record of operating in a regulated environment;

- (b) application of transformative technology in the development and delivery of financial services, such as scalable and agile tech stack built on microservices architecture;
 - (c) access to deep and robust customer analytics that may be utilised to improve and expand access to and responsible usage of financial services;
 - (d) ability to continuously serve as a source of financial strength to the proposed licensed digital bank; and
 - (e) with respect to licensed Islamic digital banks, the requisite Shariah expertise to effectively carry on Islamic digital banking business.
- G** 8.3 The Bank may require a shareholder who holds an aggregate interest in shares of 50% or more in a proposed licensed digital bank to organise all its financial and financial-related subsidiaries under a financial group, headed by a single apex entity, which should be either a licensed institution or a financial holding company. In this regard, shareholders are encouraged to refer to the Bank's paper on *Approach to Regulating and Supervising Financial Groups* and the *Acquisition Procedures*.
- G** 8.4 The presence of strong and well-managed domestic banking institutions is important for the stability of the financial system and its orderly growth and development. In this respect and in consideration of the factors set out in Schedule 6 of the FSA and IFSA, the Bank will review whether the application will be in the best interest of Malaysia, including the degree and significance of Malaysian participation in the financial sector. In this regard, preference will be accorded to an application where the controlling equity interest in the proposed licensed digital bank resides with Malaysians.

9 Application and review process

- S** 9.1 An applicant shall submit an application that complies with the procedures set out in Part C of the *Licensing Procedures*.

10 Submission of business plan

- S** 10.1 An applicant shall submit to the Bank the information and documentation required under Part D of the *Licensing Procedures*.
- S** 10.2 With respect to the submission of a business plan, the applicant is required to submit to the Bank a business plan that contains the information required under paragraph 12 of the *Licensing Procedures*, as well as the additional requirements outlined in paragraphs 10.3 below. Notwithstanding that paragraph 12 of the *Licensing Procedures* requires the submission of a three-year business plan, in the case of an application to carry on a digital banking business or an Islamic digital banking business, the applicant shall submit a business plan that covers a five-year period.
- S** 10.3 The overall business plan shall –
- (a) be aligned with the limit on total asset size during the foundational phase, as provided in paragraph 13.1;
 - (b) emphasise and be aligned with financial inclusion objectives of serving the unserved and/or underserved segments. For example, in terms of growth and performance targets, infrastructure, expertise and systems. The plan shall include –
 - (i) description of the specific unserved and/or underserved target segments. The identification of the target segment should be supported by market studies and an analysis of the market gaps;
 - (ii) proposed financial products and services that will be offered. The applicant should explain how the solutions to be offered will address the specific needs of the target segment, promote responsible usage of financial services and create positive impact to the target segment. An example would be a solution that encourages the build-up of savings or financial buffers by the unserved and/or underserved segments; and
 - (iii) indicate in the pro-forma financial statements, the share of business from the identified unserved and/or underserved segments relative to the overall projected operations.
 - (c) include a projected path to profitability that demonstrates a sustainable business model. Where the applicant does not expect the proposed

licensed digital bank to break even within the first five years, the applicant shall indicate in the pro-forma financial statements the expected year that the proposed licensed digital bank will break even;

- (d) include an analysis of the reasonableness of the key assumptions that forms the basis of the pro-forma financial statements;
- (e) identify the risks associated with the business activities and strategies to manage such risks;
- (f) indicate talent requirement (in numbers and type of skills needed) over the five-year period, and how the required numbers and skills will be met in areas related to technology and risk management, and where applicable, requisite Shariah expertise;
- (g) outline the measures to address customer queries or complaints, given the expectation for digital banks to be operating primarily or wholly through digital or electronic means as described in paragraph 17;
- (h) outline the measures to reach compliance with equivalent regulatory requirements at the end of the foundational phase as described in paragraph 15.2. The plan shall include the timeframe and resources required to build the capability for full compliance; and
- (i) indicate, for applicants who intend to offer financial services through agents or third party intermediaries, a description of the proposed agency arrangement, which at minimum shall cover –
 - (i) description on the role of and the customers to be served by the agents;
 - (ii) governance and oversight of the agents, including selection criteria, incentive structure, conduct requirements and monitoring framework; and
 - (iii) safeguards for consumer protection and preservation of customer confidentiality.

- S** 10.4 At application stage, the applicant is required to obtain an independent external assurance on the feasibility of the business plan that includes an opinion on –
- (a) the comprehensiveness of the business plan in capturing the Bank’s requirement in paragraphs 10.1, 10.2 and 10.3, and an identification of key gaps, if any;
 - (b) whether the principal assumptions underlying the pro-forma financial statements have been adequately disclosed; and

- (c) whether the assumptions are reasonable and realistic having regard to the proposed target market, product and services, funding strategy and operating environment.

The Bank requires for the independent external party to have a good track record and demonstrate expertise or relevant experience in assessing business plan financial projections.

- S** 10.5 After license is granted and prior to commencement of operations, the licensed digital bank is required to undergo an operational readiness review as described in paragraphs 10.17 and 10.18 of the *Licensing Procedures*. In addition, the Bank requires the licensed digital bank to obtain and submit to the Bank an independent external assurance that the internal controls and IT systems of the licensed digital bank are in place to support its operations in a sound and prudent manner. These include controls and IT systems to ensure compliance with the prudential standards issued by the Bank on capital, liquidity, risk management, consumer protection, AML/CFT, Shariah matters and cyber security. The Bank requires for the independent external party to have a good track record and demonstrate expertise or relevant experience in assessing adequacy of internal controls and IT systems for compliance with prudential standards.
- S** 10.6 The independent external party in paragraphs 10.4 and 10.5 must be free from any conflict of interest or potential conflict of interest that could impair its ability to provide an objective assurance and/or assessments on the applicant's business plan and operational readiness.

11 Submission of exit plan

- S** 11.1 As licensed digital banks may adopt new, untested business models, applicants shall be prepared to exit the business in the event that such business models prove to be unsustainable or ineffectual. An exit plan is thus necessary to ensure that the licensed digital bank is able to unwind its business operations voluntarily without any regulatory intervention and in an orderly manner without causing disruption to its customers and the financial system.
- S** 11.2 An applicant shall submit to the Bank an exit plan for the first five years of the applicant's operations. In this regard, the exit plan must include the following –
- (a) potential management triggers for exiting the business which clearly defines unsustainable business models and/or the materialisation of risks

beyond the applicant’s own risk appetite. These indicators may comprise of but is not limited to –

- (i) capital-related triggers such as leverage ratio and common-equity Tier 1 ratio;
 - (ii) liquidity-related triggers such as loan-to-funds ratio;
 - (iii) earnings-related triggers such as return-on-assets and returns on equity; and
 - (iv) asset quality-related triggers such as non-performing loan ratio;
- (b) likely options and related measures to be taken for exiting that minimises disruption to its customers and the financial system;
 - (c) potential impediments to the execution of identified exit options and preparatory measures to mitigate the impact of such impediments; and
 - (d) sources of funding and liquidity for exit (excluding any form of assistance from the Bank) and the estimated timeframe to exit the business.

The full implementation of the exit plan must result in the liquidation of the licensed digital bank’s business or sale to a third party.

- S** 11.3 For purposes of paragraph 11.2, within the exit plan, the applicant is required to demonstrate the following–
- (a) the necessary capabilities required to extract and aggregate real time data on depositors and customers upon request, including up-to-date contact information and alternative bank accounts to facilitate any payout; and
 - (b) the necessary capabilities and resources required to ensure continuity of services throughout the implementation of the exit plan, with a specific focus on continuity of services under outsourcing arrangements.

- S** 11.4 For the purpose of the requirements under paragraphs 11.2 and 11.3, an applicant shall provide a comprehensive description of its exit plan which includes the following information–

Table 1: Required content of the exit plan

Coverage	Details
Governance to support informed decision making	<ul style="list-style-type: none"> • Well-defined roles and responsibilities of the board, senior management and business units

in the activation of exit plan	<ul style="list-style-type: none"> • Policies, procedures and management information systems to inform and support decision making and smooth coordination of exit plan execution
Exit triggers	<ul style="list-style-type: none"> • Identification of factors and indicators/thresholds that will prompt activation/execution of the exit plan including but not limited to compliance to regulatory requirement at the end of the 5-year observation period • Processes for continuous monitoring of factors and indicators/thresholds
Execution of measures that enable an orderly exit from the business without causing disruption to third-parties, in particular customers and counterparties	<ul style="list-style-type: none"> • Identification of possible actions that can be undertaken under different scenarios; taking into account cross-border considerations and stages of development/complexity of the applicant’s business • Identification of possible and credible funding sources to implement the exit plan • Description of operational dependencies on external parties (i.e. applicant’s dependence on external service providers) and its associated costs throughout the exit phase to ensure smooth operational continuity throughout the exit phase
Communication and engagement strategy (including to the Bank) to mitigate unintended consequences	<ul style="list-style-type: none"> • Identification of key stakeholders, including depositors, relevant regulators and authorities, counterparties, service providers, general public, etc. • Information needs of respective stakeholders • Medium, timing and frequency of communication • Person(s) responsible for ensuring the effective coordination and execution of the communication and engagement strategy

- G** 11.5 As a starting point in developing the exit plan, an applicant may refer to the exposure draft on *Recovery Planning* to be issued by the Bank to guide applicant’s selection and calibration of exit triggers as well as assessment of efficacy and feasibility of its measures.

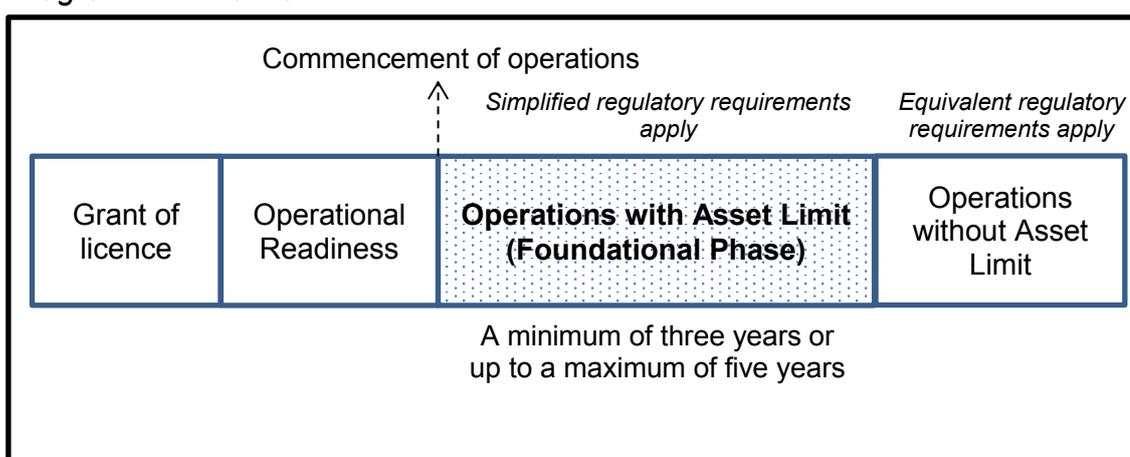
- S** 11.6 At the point of application, applicant is required to submit an exit plan which broadly covers all aspects specified in paragraph 11.4 and with detailed elaboration on exit triggers and execution of measures. Further details on operational aspects such as the exact governance policies, technical details of the management information system and detailed information needs of respective stakeholders can be submitted later for the Bank’s review, prior to commencement of operations.
- S** 11.7 Prior to commencement of operations, the Board of the licensed digital bank is required to endorse the exit plan including the refined operational details as stated in paragraph 11.6. The licensed digital bank is required to keep its exit plan updated and to notify the Bank as and when there are material changes to its structure or operations that can significantly affect its exit plan.

PART C FOUNDATIONAL PHASE

12 Overview

- S** 12.1 A licensed digital bank shall operate with an asset limit for a period of up to five years from its commencement of operations (‘foundational phase’). An overview of the timeline of the operational progression of the licensed digital bank is illustrated in Diagram 1.

Diagram 1: Timeline



- S** 12.2 During the foundational phase, a licensed digital bank shall:

- (a) maintain at all times a minimum amount of capital funds of RM100 million; and
- (b) be subject to the business limitation as described in paragraph 13.1 and the regulatory framework described in paragraph 14 below.

13 Business limitation

- S 13.1 A licensed digital bank shall ensure that its total size of assets do not at all times exceed the limit of RM 2 billion during the foundational phase.

14 Regulatory framework

- S 14.1 A licensed digital bank shall comply with the equivalent regulatory requirements applicable to a licensed bank or a licensed Islamic bank, except for the requirements specified in Table 2 below¹.

Table 2: Areas of regulatory simplification or exemption during the foundational phase

	Areas of simplification or exemption to the existing regulatory framework
Capital Adequacy Requirements ^{2,3}	<ul style="list-style-type: none"> • Minimum Total Capital Ratio (TCR) of 8% with simplified calculations of the following Risk-Weighted Assets: <ul style="list-style-type: none"> a) Credit Risk; b) Operational Risk; and c) Market Risk • Only Common Equity Tier 1 (CET1) capital is recognised in the computation of TCR • Exempted from capital buffer requirements⁴
Liquidity	<ul style="list-style-type: none"> • Simplified liquidity requirements • The Bank may impose Liquidity Coverage Ratio (LCR)⁵ and Net Stable Funding Ratio (NSFR)⁶

¹ Further details on the simplified requirements applicable to a licensed digital bank during the foundational phase will be published during the consultation period.

² Refer to *Capital Adequacy Framework (Basel II – Risk-Weighted Assets)* policy document.

³ Refer to *Capital Adequacy Framework (Capital Components)* policy document.

⁴ This includes Capital Conservation Buffer and Countercyclical Capital Buffer.

⁵ Refer to *Liquidity Coverage Ratio (LCR)* policy document.

⁶ Refer to *Net Stable Funding Ratio (NSFR)* policy document.

	requirements where the digital bank conducts significant maturity transformation
Stress testing ⁷	Exempted
Public Disclosure (Pillar 3)	Simplified requirements

- S** 14.2 A licensed digital bank shall have regular engagements with the Bank during the foundational phase. This is to ensure that the licensed digital bank achieves a consistent and gradual progress in complying with equivalent regulatory requirements applicable to a licensed bank or a licensed Islamic bank.
- G** 14.3 For requirements other than those set out in Table 2, the Bank will apply the equivalent requirements applicable to banking institutions⁸ in a manner that is proportionate and commensurate to the risks undertaken by the licensed digital bank.

15 End of the foundational phase

- G** 15.1 A licensed digital bank may after three years from the commencement of its operations, submit to the Bank for the foundational phase to end and for the business limitation to be uplifted.
- G** 15.2 In considering the application in paragraph 15.1, the Bank will assess whether the licensed digital bank has to the Bank's satisfaction –
- complied with all applicable laws and regulatory requirements;
 - achieved a minimum amount of capital funds of RM300 million; and
 - shown satisfactory progress in achieving the committed value propositions as described in its business plan.
- S** 15.3 By the end of the fifth year from the commencement of their operation, all licensed digital banks shall comply with all equivalent regulatory requirements applicable to a licensed bank or licensed Islamic bank and achieve a minimum amount of capital funds of RM300 million. The business limitation referred to under paragraph 13.1 shall no longer be applicable.

⁷ Refer to *Stress Testing* policy document.

⁸ This includes requirements relating to consumer protection and AML/CFT

- S** 15.4 A licensed digital bank that fails to fulfil any of the requirements under paragraph 15.2 by the end of the fifth year from the commencement of its operation may be subject to an enforcement action, including a direction to implement its exit plan or revocation of licence.
- G** 15.5 The Bank generally expects for the licensed digital bank to continue serving the underserved or unserved segments as part of its business operations, even after the end of the foundational phase.

PART D BUSINESS ACTIVITIES AND PRESENCE

16 Business of paying or collecting cheques

- G** 16.1 To facilitate the performance of its business of paying or collecting cheques, a licensed digital bank may –
- (a) enter into a commercial arrangement to appoint another licensed bank or licensed Islamic bank that is an e-SPICK member to manage the physical collection of cheques; or
 - (b) use technology to minimise the physical collection of cheques, subject to adequate safeguards.
- S** 16.2 For the purpose of paragraph 16.1, the licensed digital bank shall ensure that any of its commercial arrangements comply with all the policy documents applicable to licensed banks and licensed Islamic banks including the policy document on *Outsourcing*.

17 Physical access points

- S** 17.1 In line with section 46(1) of the Companies Act 2016, a licensed digital bank is required to establish a registered office in Malaysia. A licensed digital bank shall ensure that its sole registered office sufficiently allows the Bank to communicate with the licensed digital bank during the supervisory process, including for the purposes of examination and engagement with senior management and the board. If the licensed digital bank intends to facilitate face-to-face customer complaints, the sole physical office shall also serve as a centre for this purpose.

- G** 17.2 A licensed digital bank may participate in the Shared ATM Network and any other cash-out services offered by PayNet.

- G** 17.3 A licensed digital bank may be permitted to offer financial services through agents, subject to the Bank's approval. Factors that would be taken into consideration include ensuring that the arrangements are conducted in a safe and sustainable manner with appropriate safeguards to address risks, as well as protect the interest of customers.

- S** 17.4 A licensed digital bank is not allowed to establish any physical branches.