



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

# **Approach to Regulating and Supervising Financial Groups**

Issued on 21 May 2014

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## PART A OVERVIEW

### 1. Introduction

- 1.1. The transformation of the Malaysian financial landscape in recent years has seen the emergence of financial groups<sup>1</sup> which operate across a wide range of activities and markets domestically as well as in the region. This development has enabled financial groups to realise business synergies through greater economies of scale and the diversification of risks and sources of income.
- 1.2. This development however also presents new challenges in regulating and supervising licensed institutions<sup>2</sup> which belong to such financial groups. The complex relationships<sup>3</sup> between licensed institutions and other affiliated entities<sup>4</sup> introduce additional sources of risk which can adversely affect the safety and soundness of licensed institutions, with broader implications for the stability of the Malaysian financial system as a whole. These include, but are not limited to:
- i. contagion risk arising from operational, financial and reputational associations between entities within the financial group that can

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<sup>1</sup> A “financial group” shall refer to either a financial holding company approved by the Bank or a licensed institution, and a group of related corporations primarily engaged in financial services or services which are in connection with or for the purposes of such financial services.

<sup>2</sup> A “licensed institution” shall refer to any person licensed under section 10 of the FSA or section 10 of the IFSA to carry on a licensed business.

<sup>3</sup> Such relationships may include those in the form of:

- (i) financial integration (e.g. existence of cross guarantees, centralised funding arrangements, cross-default clauses, expectation of support from the licensed institution);
- (ii) operational integration (e.g. insourcing and sharing of operational facilities, and common directors, management and Shariah committee members); and
- (iii) reputational integration (e.g. cross-selling of products, sharing of common marketing and/or branding platform, public association of the entity with the licensed institution in the financial group).

<sup>4</sup> An “affiliate” or “affiliated entity” shall refer to an entity that controls, or is controlled by, or is under common control with, a licensed institution. In addition, it also includes relationships with other companies where non-controlling interests exists, but where significant influence is exercised. This may include a significant shareholder, joint venture, or special purpose entity, whether domestic or foreign, and whether regulated or not regulated by the Bank.

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undermine the safety and soundness of licensed institutions which are otherwise prudentially sound;

- ii. heightened conflicts of interest between licensed institutions and related parties which can be further compounded by overlapping directors and/or management between entities in the group;
- iii. regulatory arbitrage arising from the different degrees of prudential regulation applied to entities within the group; and
- iv. increased challenges in the resolution of licensed institutions due to complex group structures and operational interdependencies arising from centralised and shared services.

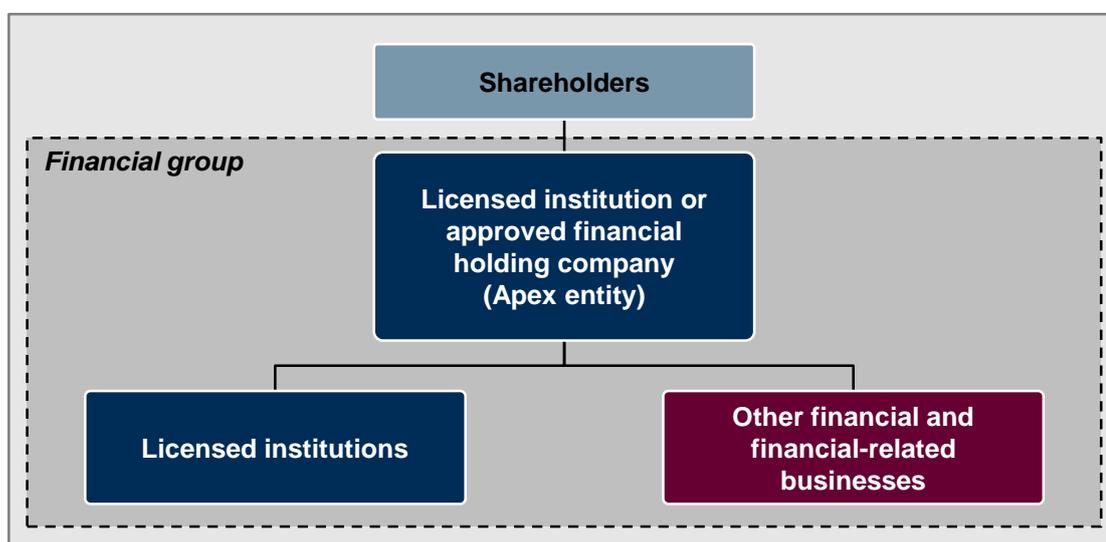
1.3. To ensure that these issues are effectively addressed, it is important that the financial soundness of a licensed institution is assessed against a wider risk perimeter, covering the full spectrum of group-wide activities and risks. This document sets out the Bank's approach in enhancing the current prudential regulatory and supervisory framework to address risks to licensed institutions that are part of financial groups pursuant to the exercise of the Bank's oversight powers over financial groups as provided under Part VII of the Financial Services Act 2013 (FSA) and Part VIII of the Islamic Financial Services Act 2013 (IFSA) respectively.

## **2. Broad approach**

2.1. The regulatory and supervisory framework for financial groups aims to strengthen the oversight of financial groups such that material risks from activities undertaken by affiliates are effectively managed and controlled on a group-wide basis and do not undermine the safety and soundness of licensed institutions within the group. A comprehensive approach to the oversight of financial groups is particularly important as financial groups increasingly operate and manage their businesses on an integrated basis across corporate and national boundaries.

2.2. Under the framework, prudential regulation and supervision by the Bank will be applied on a consolidated basis. This will be achieved through the implementation of group-wide prudential standards through the “apex entity” of the financial group (as illustrated in Figure 1), which will either be a licensed institution or a financial holding company approved by the Bank<sup>5</sup>. The apex entity will be responsible for establishing and implementing group-wide policies and procedures that ensure the financial group’s compliance with prudential requirements on a consolidated basis. Consolidated level prudential standards will be implemented in a manner that acknowledges the local business considerations of various entities within the group and requirements of host jurisdictions or other authorities. This will include allowing the entity-level board and senior management to exercise their respective legal, regulatory and governance responsibilities<sup>6</sup>.

**Figure 1 – Illustration of a financial group**



<sup>5</sup> Pursuant to section 112 of the FSA 2013 or section 124 of the IFSA.

<sup>6</sup> The group policy should allow an entity within the group to adopt and comply with the requirement of a host jurisdiction or another authority if it is stricter than that required by the Bank. As highlighted in paragraph 2.7, the Bank will continue to work with other authorities to ensure effective coordination that minimise regulatory gaps, duplication and inconsistencies in regulatory requirements and to support effective consolidated supervision.

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- 2.3. The apex entity will further serve as the main reference point for supervisory activities where possible, including obtaining information for the purposes of assessing risks posed by the financial group to licensed institutions within the group, reviewing the effectiveness of group-wide oversight and risk management arrangements, and requiring corrective measures to be taken to mitigate any identified risks to the financial group as a whole or any licensed institution within it. Accordingly, appropriate arrangements should be in place to allow for the aggregation and sharing of information within a financial group to the extent permitted by regulatory requirements that apply in the jurisdictions in which the foreign affiliates operate.
- 2.4. Part B of this paper describes the Bank's prudential framework for financial groups going forward, which includes the application of prudential standards on a consolidated basis for the financial group as a whole. To a certain extent, where financial groups are headed by licensed institutions, such requirements already exist. For example, financial groups headed by banking institutions are presently subject to group-wide capital requirements under the Capital Adequacy Framework, which requires the application of capital rules on banking institutions on both an entity and consolidated basis.
- 2.5. The prudential framework described in this paper complements the Bank's regulatory and supervisory focus on the licensed institution as a standalone entity. Group-wide requirements will be introduced where existing entity level requirements do not sufficiently address risks arising from other entities and affiliates not under the direct oversight of the Bank. For instance, a group-wide limit on large exposures is necessary to avoid excessive concentrations of exposures to a single counterparty by different entities across the financial group. Requirements at the group level will also be developed to ensure that all financial groups, regardless of how they are structured and organised<sup>7</sup>, are subject to effective regulatory and supervisory oversight, thereby limiting the

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<sup>7</sup> For example, whether a group is headed by a licensed institution or by a financial holding company.

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potential for regulatory arbitrage and competitive distortions across financial groups with different structures.

- 2.6. Entity-level requirements will continue to remain central in the prudential framework going forward. In addition to maintaining existing requirements, such as those concerning capital adequacy requirements, scope for introducing additional safeguards such as strengthened requirements on transactions and exposures between the licensed institution and the wider group will also be considered.
- 2.7. The application of the prudential framework for financial groups will be supported by supervisory cooperation and coordination between the Bank and other relevant domestic and foreign authorities. At the national level, for example, the Bank will consult the Securities Commission Malaysia prior to specifying any prudential standards or issuing any directive which will impact any affiliate that carries out regulated activities or provides capital market services as defined under the Capital Markets and Services Act 2007. The Bank will leverage on and continue to strengthen home-host arrangements to ensure effective oversight of cross border operations of both domestic and foreign-owned financial groups. These arrangements acknowledge the statutory responsibilities of respective authorities and seek to ensure effective coordination between authorities to minimise regulatory gaps, duplication and inconsistencies in regulatory requirements and to support effective consolidated supervision.

### **3. Scope of application**

- 3.1. The regulatory and supervisory framework for financial groups will be approached through identification of the apex entity of a financial group.

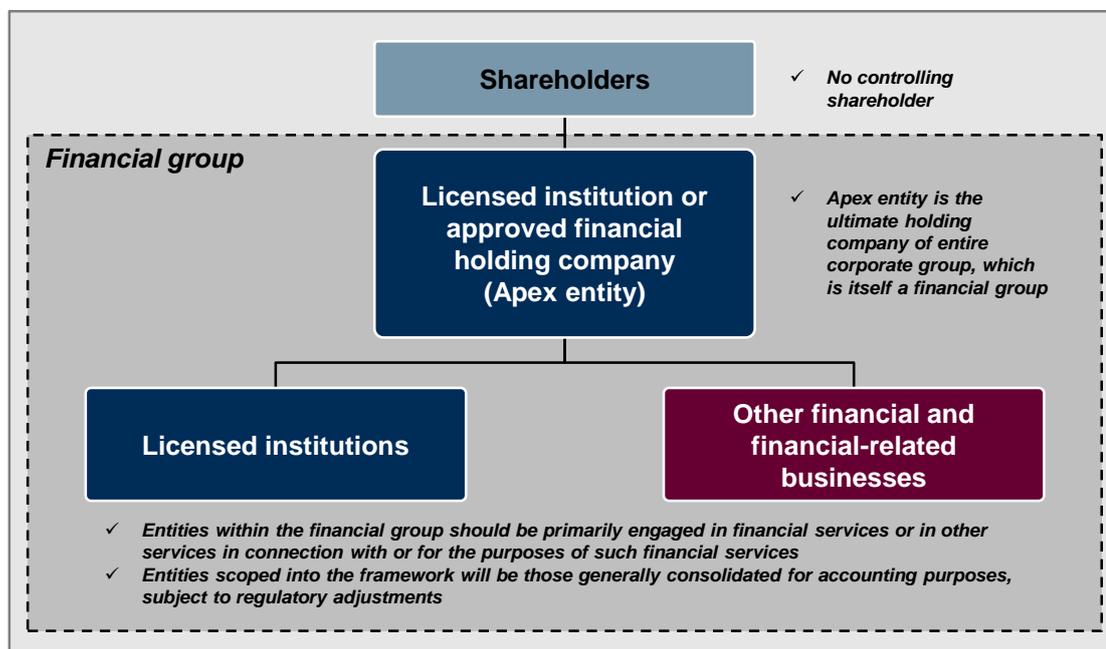
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- 3.2. In general, the apex entity should be the ultimate holding company<sup>8</sup> of the corporate group to which a licensed institution belongs. This corporate group should be a financial group, with entities in the corporate group primarily engaged in financial services or in other services in connection with or for the purposes of such financial services. The apex entity shall either be a licensed institution or a financial holding company approved by the Bank.
- 3.3. Clear and well-defined boundaries of the financial group are essential to ensure that risks arising from all relevant downstream entities of the financial group which have the potential for posing a material risk to licensed institutions are appropriately managed and monitored. In most instances, the starting point for determining the regulatory scope of consolidation will be the accounting scope. However, the Bank may also apply other additional prudential measures to ensure that material risks to licensed institutions within a financial group arising from significant dealings between the licensed institutions and affiliates which are not consolidated for accounting purposes are appropriately managed. In general, such measures may be required where such risks are not adequately addressed by entity-level prudential safeguards.

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<sup>8</sup> Where it is not itself a subsidiary of any other body corporate.

**Figure 2 – Illustration of a financial group organised in line with paragraphs 3.1 to 3.3**



3.4. The Bank will generally not prescribe the structure for financial groups, including how the financial group organises its subsidiaries or whether intermediate holding companies are used. It is expected, however, that financial groups must not adopt overly complex or opaque group structures that hamper their effective risk management, or impede the effective supervision and resolution of licensed institutions and the financial groups to which they belong<sup>9</sup>. Where an apex entity for the group has already been identified, intermediate holding companies under the apex entity will not generally be required to be approved as financial holding companies under the FSA and IFSA.

3.5. Exceptions to the approach set out above are detailed out in the following paragraphs.

<sup>9</sup> Consistent with principles 11 and 12 of *Risk Governance*.

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***Financial groups operating in both banking and insurance/takaful sectors***

- 3.6. A number of financial groups in Malaysia operate in both the banking and insurance/takaful sectors<sup>10</sup>. In such cross-sectoral financial groups, reliance on the application of group-wide requirements at the level of the apex entity alone may not be adequate in capturing the distinct risks of the different sectors, particularly where multiple entities operate in either sector. Given the inherent differences in the nature and scope of banking and insurance/takaful prudential requirements, the broad brush application of similar requirements on different activities is likely to render the framework ineffective and create opportunities for regulatory arbitrage<sup>11</sup>.
- 3.7. The Bank may therefore require a clear separation between the banking and insurance/takaful entities within cross-sectoral financial groups. This will ensure that an appropriate level of supervisory focus is devoted to the distinct businesses of a cross-sectoral financial group, while also facilitating the implementation of consolidated sectoral prudential standards such as those in the areas of capital adequacy and prudential limits.
- 3.8. For financial groups in Malaysia, this is likely to entail the formation of an insurance/takaful sub-group within the larger financial group to house all insurance and takaful entities. This sub-group should be headed by an apex entity which shall be either an intermediate financial holding company approved by the Bank<sup>12</sup> or a licensed insurer/takaful operator<sup>13</sup> (refer to Figure 3). The requirement for a clear separation between banking and

<sup>10</sup> In other markets, such financial groups are also commonly referred to as “financial conglomerates”, “universal banking groups” or “mixed financial groups”.

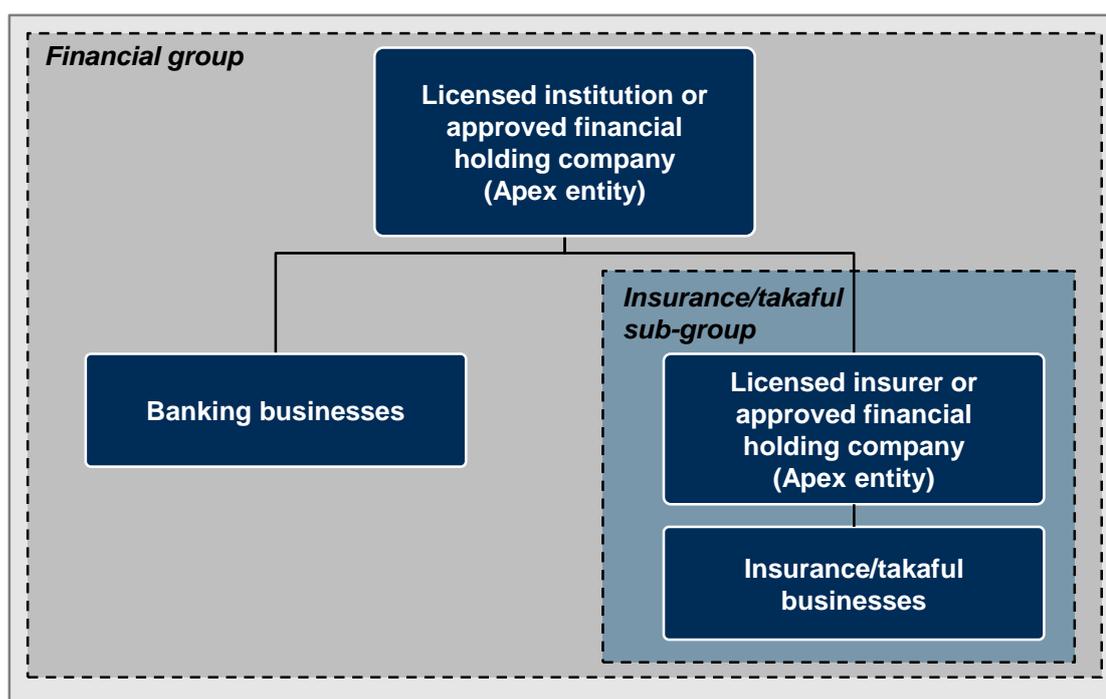
<sup>11</sup> Ongoing efforts both at the domestic and international levels to align standards across sectors such as those in the areas of corporate governance and risk management, while intended mainly to ensure that risks are managed in a sound and prudent manner across the banking and insurance/takaful sectors, also have the effect of creating standards that can be applied on cross-sectoral financial groups. Nonetheless, full harmonisation of standards across sectors continue to remain a work in progress given the significant variations in the nature, approach and focus of sectoral rules which reflect fundamental differences in the underlying businesses and activities across sectors.

<sup>12</sup> Pursuant to section 113 of the FSA and section 125 of the IFSA which provide the Bank with the flexibility of approving more than one financial holding company within the same corporate group.

<sup>13</sup> A licensed takaful operator will be allowed to hold only other takaful operators or other Islamic financial services businesses.

insurance/takaful activities within a financial group will take into consideration the materiality of the insurance/takaful activities within the group<sup>14</sup> and any specific regulatory requirements which may apply to entities operating in other jurisdictions.

**Figure 3 – Illustration of a financial group operating in both banking and insurance/takaful sectors**



### ***Foreign-owned licensed institutions***

3.9. Foreign-owned licensed institutions<sup>15</sup> are also exposed to group risks which can adversely affect their safety and soundness, and the stability of the Malaysian financial system. It is therefore also important for the Bank to be able to draw a complete assessment of all material sources of risk faced by a foreign-owned licensed institution arising from the activities of the group. As elaborated in paragraph 2.7, to the extent that the foreign-owned licensed

<sup>14</sup> Such as where there are two or more insurance/takaful entities licensed by the Bank, or where there are other entities carrying out activities in connection with or for purposes of its insurance/takaful business. The Bank will also consider the size of the combined insurance/takaful businesses, or the extent of insurance/takaful activities conducted outside Malaysia.

<sup>15</sup> A licensed institution ultimately controlled and/or majority owned by a financial institution which is: (i) operating in a jurisdiction other than Malaysia; and (ii) regulated and supervised by a prudential regulatory authority in that jurisdiction (i.e. the home supervisor).

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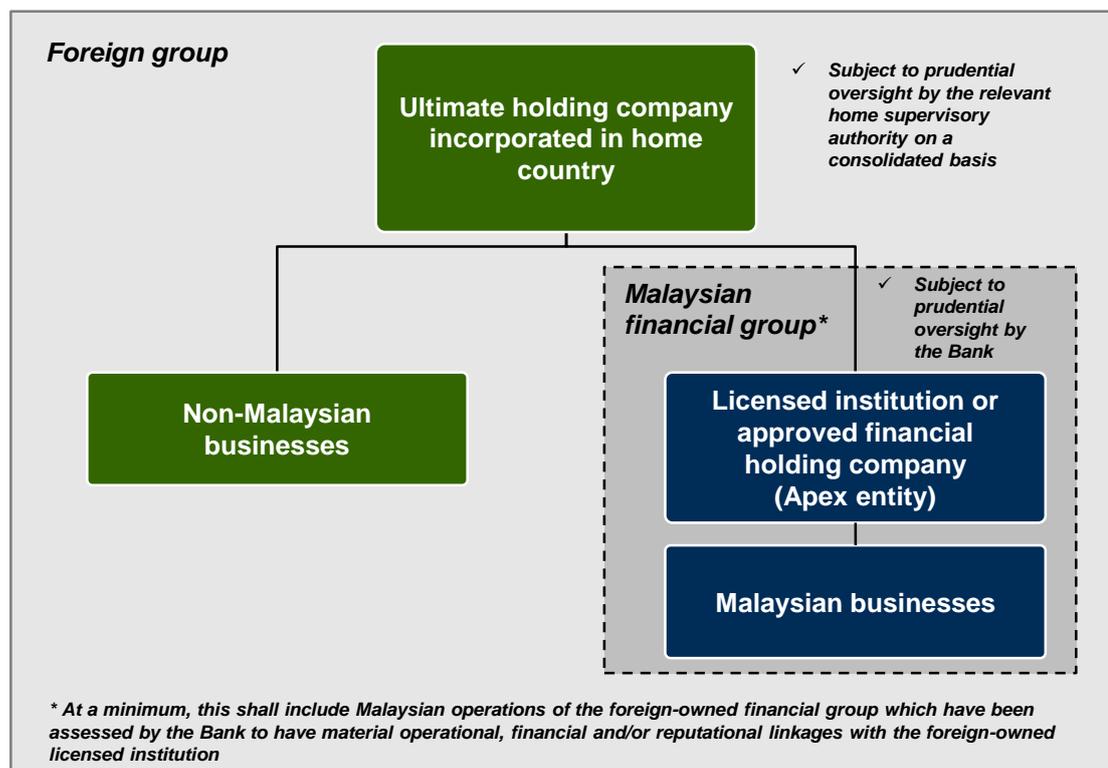
institution and the group to which it belongs are already subject to equivalent prudential oversight by other supervisory authorities in the home jurisdiction, the Bank will leverage on existing avenues for cross-border exchanges of information and supervisory co-operation to achieve its supervisory objectives. Where such a foreign group also has other operations in Malaysia and such operations are established to have operational, financial and reputational linkages with a licensed institution, the Bank is empowered under the FSA and IFSA to examine and request information from the affiliates of licensed institutions to facilitate the Bank's assessment of risks to the licensed institution. Where such operations are subject to oversight by another authority in Malaysia, the Bank will coordinate with the relevant authority in the conduct of examinations.

- 3.10. The Bank views this established framework for regulating and supervising foreign-owned licensed institutions to be generally appropriate<sup>16</sup>. However, there may be circumstances in which additional measures beyond an entity-level approach to regulation and supervision, supplemented by supervisory cooperation arrangements, are determined by the Bank to be necessary to address risks to financial stability in Malaysia. This would be the case where a foreign-owned licensed institution is systemically important in Malaysia and existing prudential arrangements are determined to be inadequate to mitigate risks from the activities of the group to the licensed institution and, by extension, to Malaysian financial system stability. Under such circumstances, the Bank may: (i) require the combined operations of such foreign-owned licensed institutions and their Malaysian affiliates to be organised under a single apex entity in Malaysia which shall be either a licensed institution or financial holding company approved by the Bank (refer to Figure 4); or (ii) limit intra-group transactions and exposures of such foreign-owned licensed institutions with entities within the group.

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<sup>16</sup> Accordingly, the group-wide prudential requirements set out in Part B of this paper will not apply in these general circumstances.

**Figure 4 – Illustration of a group structure where the Bank has required the combined operations of a foreign-owned licensed institution and its Malaysian affiliates to be organised under a single apex entity in Malaysia<sup>17</sup>**



### ***Licensed institutions operating as part of a wider industrial conglomerate***

3.11. As a matter of policy, the Bank seeks to limit the scope of involvement of licensed institutions and their subsidiaries in non-financial activities given the inherent differences in the nature of risks involved and the complexity that this creates for the assessment and control of risks on a group-wide basis. The involvement in non-financial undertakings by licensed institutions may therefore be allowed only to the extent that it is inherent to the provision of financial services, such as in the case of Islamic finance. As the involvement in real sector activities is inherent and integral to effectively delivering Islamic financial services and in the implementation of Shariah contracts, such activities are considered as part of the Islamic financial business of the

<sup>17</sup> Based on the considerations in paragraph 3.10.

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relevant licensed institution and are subject to prudential limits to mitigate contagion risks to licensed institutions within the group.

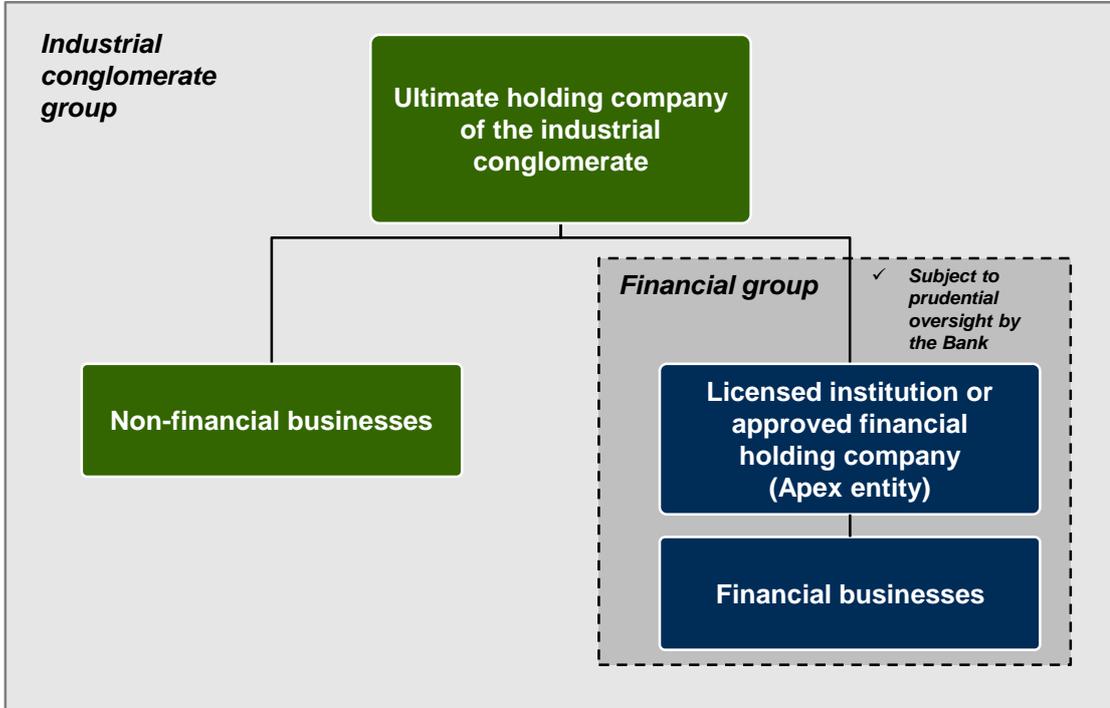
3.12. These concerns can also arise for industrial conglomerates that have controlling equity interests in licensed institutions. Allowing industrial conglomerates to have controlling interests in licensed institutions may also contribute to increased moral hazard as a result of assumptions that the public safety net will be extended to the controlling entity, and by implication, other entities within the industrial conglomerate. It also significantly complicates the orderly resolution of licensed institutions.

3.13. Where controlling equity interests by industrial conglomerates over licensed institutions have already existed prior to the FSA and IFSA coming into effect, the Bank will require a clear separation between the wider industrial conglomerate and the financial group<sup>18</sup>. This will allow the Bank to direct its primary supervisory focus on the financial group, while limiting the potential for risk contagion emanating from the wider industrial conglomerate which may undermine the safety and soundness of licensed institutions. Accordingly, all financial and financial-related activities within the industrial conglomerate should be organised under a financial group which should be headed by a single apex entity which shall be either a licensed institution or a financial holding company approved by the Bank (refer to Figure 5).

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<sup>18</sup> This requirement will also apply if an industrial conglomerate emerges as a controlling shareholder of a licensed institution in the course of intervention and failure resolution actions undertaken by Perbadanan Insurans Deposit Malaysia, pursuant to its powers in the Malaysia Deposit Insurance Act 2011.

**Figure 5 – Illustration of a financial group operating as part of a wider industrial conglomerate**



3.14. The Bank will also assess the need to further strengthen prudential standards to mitigate the risks arising from transactions and relationships between the regulated financial group and the wider corporate conglomerate. This includes standards relating to intra-group transactions and exposures, governance and shared branding strategies.

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## **PART B            PRUDENTIAL FRAMEWORK FOR FINANCIAL GROUPS<sup>19</sup>**

### **4.     Corporate governance, risk management and internal controls**

- 4.1. With the close linkages and high levels of integration that exist between licensed institutions and the financial groups to which they belong, matters which concern the group as a whole may have a direct bearing on the business direction and risk profile of the affiliated licensed institutions. Effective prudential oversight of corporate governance, risk management and internal controls at the financial group level is therefore essential to ensuring that these meet and support the objective of fostering the safety and soundness of licensed institutions.
- 4.2. In this connection, the corporate governance, risk management and internal control framework applicable to licensed institutions, including areas where planned enhancements are already underway, will be extended to the apex entity to be complied with on a group-wide basis. These will include the implementation of standards on corporate and risk governance (including fit and proper requirements), internal and external audit, data management and MIS, as well as business continuity management. The Bank will also assess the need to supplement the overarching framework with more specific guidance on the oversight and management of group-wide credit, market, operational and liquidity risks. Emphasis will also be placed on strengthening the role of market discipline through group-level transparency and disclosure requirements. In safeguarding the integrity of the financial system, the Bank will require financial groups to implement sound anti-money laundering and

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<sup>19</sup> Details of the prudential requirements covered in this part will be set out in the relevant prudential standards that will be issued in due course. In developing and implementing these prudential standards, the Bank will engage other relevant authorities as appropriate. As is the practice of the Bank, the industry will also be provided with the opportunity to submit feedback on the proposed standards when concept papers of these standards are issued.

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counter financing of terrorism (AML/CFT) policies and procedures on a group-wide basis.

- 4.3. The Bank will clarify its expectations concerning the roles and responsibilities of the board and senior management of apex entities in respect of their oversight over group-wide operations, as well as that of control functions which carry group oversight responsibilities. The ultimate responsibility of ensuring that the standards are complied with on a consolidated basis will rest with the board and senior management of the apex entity. Financial groups may elect to place specific group oversight functions (e.g. group risk management) in entities within the group other than the apex entity, subject to clearly-defined accountability structures and effective control of such functions demonstrated by the apex entity.
- 4.4. Prudential standards will generally not be issued directly to affiliates of licensed institutions<sup>20</sup> not regulated by the Bank. However, it is expected that the apex entity will comply with and implement the standards in a manner that provides sufficient coverage of material risks arising from the activities of entities within the financial group. This will include the apex entity, where relevant, requiring policies and procedures to be put in place in individual affiliates to support the implementation of group-wide standards. The Bank expects that the apex entity must also have the ability to collect information from, and direct remedial or corrective actions by group entities which present material risks to licensed institutions or the group as a whole.
- 4.5. Group-level standards will be implemented in stages, with a priority on corporate and risk governance standards. Group-level corporate and risk governance standards will set out an expectation for the board of the apex entity to observe sound governance and risk management practices in

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<sup>20</sup> Section 115(3) of the FSA and section 127(3) of the IFSA allows the Bank to specify standards on prudential matters to a subsidiary of a financial holding company if the Bank is of the opinion that the activities of such a subsidiary may pose risks to the licensed institution or its financial group.

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respect of group-wide operations that are consistent with those applied to licensed institutions. This will include requirements on board structures and processes which support the effective oversight by the apex entity's group-wide risks and strategy.

## 5. Capital and liquidity

- 5.1. A key objective of the Bank's framework for regulating and supervising financial groups is to ensure the adequacy of financial resources to support group-wide risks. While entity-level requirements are already in place to ensure that individual licensed institutions are well-resourced on a stand-alone basis for the protection of their respective depositors, investment account holders, policy owners and takaful participants, a more comprehensive assessment from a broader canvas of risk is required to ensure that risks arising from entities which are not regulated by the Bank are adequately captured. The assessment at the group level also aims to address the double or multiple gearing of capital and liquidity resources, and excessive leverage within financial groups which may undermine the financial strength of licensed institutions within the group.
- 5.2. As these requirements are generally focused on the capital adequacy and liquidity position of financial group *as a whole*, the standards will be applied on the apex entity on a consolidated basis. Accordingly, the Bank will not apply additional entity-level capital adequacy or liquidity requirements on the apex entity where it is a financial holding company<sup>21</sup>. For the avoidance of doubt, affiliates of the licensed institution which are not regulated by the Bank (including affiliates regulated by other authorities) will also not be required to comply with the Bank's capital and liquidity requirements at the entity-level as

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<sup>21</sup> A licensed institution which is also the apex entity will continue to be subject to capital and liquidity requirements at the entity level to ensure that it is adequately capitalised on a stand-alone basis to meet the obligations of its own depositors, investment account holders, policy owners and participants.

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the calculation, reporting and enforcement of these ratios will be applied to the apex entity for the group's consolidated operations.

- 5.3. The assessment of group capital adequacy and liquidity will also include a consideration of potential impediments to the effective transfer of capital and liquidity across entities within the group<sup>22</sup>. In addition, the Bank will also, as part of its supervisory reviews of the capital and liquidity positions of financial groups, assess the distribution of financial resources within the groups. This may determine the basis and level of consolidated capital and liquidity requirements applicable to a financial group.

### ***Banking groups***

- 5.4. At present, financial groups headed by *banking institutions* are subject to group capital requirements as banking institutions must comply with the Capital Adequacy Framework<sup>23</sup> not only at the entity level, but also at the consolidated level. The Bank will extend this framework to the consolidated level of financial groups headed by *financial holding companies*, which are engaged predominantly in banking activities. This will establish a consistent capital adequacy standard for regulated banking groups in Malaysia, whether headed by a banking institution or financial holding company. A consistent standard will also enhance the comparability of disclosed capital ratios of Malaysian banking groups.
- 5.5. Financial holding companies will be required to compute and disclose consolidated regulatory capital adequacy ratios based on the Capital Adequacy Framework applied to banking institutions which prescribes the definition of regulatory capital and the system of risk-based capital charges which determines the minimum regulatory capital that banking institutions

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<sup>22</sup> For example, under the Capital Adequacy Framework for banking institutions, the amount of minority interests and capital instruments issued out of subsidiaries held by third parties counting towards the consolidated capital base is limited. This is to address concerns on the availability of regulatory capital held in a subsidiary in excess of the regulatory minimum to absorb losses in the wider group.

<sup>23</sup> Which is underpinned by the Basel capital standard.

must hold. Financial holding companies will also be required to comply with the minimum capital adequacy and capital buffer levels on a consolidated basis under the Capital Adequacy Framework<sup>24</sup>:

**Table 1 – Minimum capital adequacy ratios and capital buffer requirements under the Capital Adequacy Framework**

	Capital Ratio		
	Common Equity Tier 1	Tier 1	Total
Minimum	4.5%	6%	8%
add Capital Conservation Buffer	2.5%		
add Countercyclical Capital Buffer	0 to 2.5%		
Minimum plus buffers	7 to 9.5%	8.5 to 11%	10.5 to 13%

5.6. The Bank expects financial holding companies to begin calculating group capital adequacy positions in accordance with the requirements under the Capital Adequacy Framework and submitting regulatory returns to the Bank no earlier than 2015<sup>25</sup>. Given the demands on the operational capacity required to compute and aggregate risk exposures across the group, financial holding companies are expected to take early steps to develop and implement regulatory capital reporting systems across the group (including foreign subsidiaries). The board will be required to oversee these plans.

5.7. Compliance with the regulatory minimum and buffer levels will be gradually phased in, in line with the transition arrangements applicable to banking institutions<sup>26</sup>, with the view to achieving compliance with the levels set out in Table 1 by 2019. Further details of the capital standards to be applied to financial holding companies heading groups which are engaged

<sup>24</sup> In line with the minimum and buffer requirements set out under Basel III.

<sup>25</sup> The requirements for public disclosure of group-wide capital adequacy ratios will be detailed out at a later date under the financial reporting and Pillar 3 standards for financial groups.

<sup>26</sup> Which is itself in line with the Basel Committee's recommended phase-in requirements for Basel III.

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predominantly in banking activities, including standards on Pillar 3 disclosures, will be issued for industry feedback in the second half of 2014.

- 5.8. The Bank also expects financial holding companies to have a group-wide internal capital adequacy assessment process (ICAAP) under Pillar 2, which is subject to the Bank's review, to ensure that the assessment of group capital adequacy takes into account group-wide risks that may not be adequately addressed through the minimum regulatory capital requirements. This will be required to be in place no earlier than 2017. The boards of financial holding companies will then be expected to develop and closely monitor the progress of plans to comply with ICAAP requirements at the group level. The Bank intends, together with the issuance of detailed requirements on the ICAAP, to further clarify the manner in which it expects the ICAAP of the group to relate to the conduct of the ICAAP of individual banking entities within the group. This will follow the finalisation of Pillar 1 requirements.
- 5.9. The Bank also plans to implement the remaining components of the Basel III regulatory reform package – namely the Liquidity Coverage Ratio, Net Stable Funding Ratio and the Leverage Ratio – for financial groups. While these standards will be implemented at the bank entity level in accordance with the globally-agreed timeline<sup>27</sup>, the Bank does not expect to implement any of these standards at the group level any earlier than 2018. The extended transition period for group implementation will allow banking groups to prioritise resources and efforts in complying with the Capital Adequacy Framework, while also allowing industry and supervisory attention to be focused on ensuring effective implementation of the Basel III reform package at the entity level before it is extended to the group. The Bank expects to set out more detailed transition timelines for these standards when it consults the industry on the detailed parameters for each individual standard. To allow the Bank to assess the readiness of the industry in complying with the new

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<sup>27</sup> Refer to *Implementation of Basel III*, 16 December 2011.

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standards before a final decision to implement these standards is made, the Bank will also extend to financial holding companies the requirement to regularly submit their calculated Basel III liquidity and leverage positions as part of the "observation period" reporting exercise from 2015<sup>28</sup>.

### ***Insurance and takaful groups***

- 5.10. The regulatory capital requirements for insurance/takaful companies are applied only at the entity level based on methods prescribed in the Risk-Based Capital Frameworks for insurers and takaful operators. While these arrangements currently reflect the domestic focus and relatively less complex operations of existing insurance groups, the expansion of the local insurance/takaful groups' activities in domestic and foreign markets going forward will necessitate an enhanced approach to manage capital at the group level. In this regard, the Bank intends to extend capital requirements to insurance/takaful groups through the implementation of the Risk-Based Capital Framework by insurers, takaful operators and financial holding companies on a consolidated basis.
- 5.11. Given the absence of an international capital standard for insurers, there is a wide divergence in capital standards across jurisdictions at present. This may result in consolidated capital requirements at the group level being different and potentially higher than the summation of regulated entity level capital requirements. Consolidated capital requirements for insurance/takaful groups will also need to take into account specific constraints on the transferability of capital within the group relating to participating life policy funds and takaful funds.
- 5.12. The Bank expects to implement group-wide capital standards for insurance/takaful groups headed by licensed insurers/takaful operators and financial holding companies by 2018. This will take into account developments

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<sup>28</sup> Banking institutions are already required to report their consolidated-level Basel III liquidity and leverage positions to the Bank beginning June 2013.

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to achieve a global capital standard for the insurance sector which are being led by the International Association of Insurance Supervisors to ensure that the Bank's requirements will be aligned where relevant. Pending the implementation of the group-wide capital standards, the Bank may as part of ongoing supervision require regular reporting of the capital positions of insurance/takaful groups, and the maintenance of capital buffers at the group level to cater for group-wide risks that are not adequately captured by the existing capital requirements.

## **6. Prudential requirements, restrictions and limits**

- 6.1. Prudential requirements, restrictions and limits are generally applied on licensed institutions to contain excessive risk-taking and complement other elements of the prudential framework, such as capital adequacy and risk management standards, in promoting the safety and soundness of licensed institutions. These include, among others, requirements to limit or otherwise mitigate risks arising from concentrations of exposures to a single counterparty (or group of connected counterparties), involvement in high-risk activities which may compromise the continued provision of core services by a licensed institution, conflicts of interest and transactions and exposures with related parties. In the context of financial groups, the materialisation of risks arising from the exposures, activities and relationships entered into by entities within the group, particularly those which are not regulated, and the concentration of such risks at the level of the group as a whole can have the potential for threatening the financial condition of a licensed institution.
- 6.2. In managing these risks, the Bank proposes to extend the existing framework of limits and restrictions applicable at the level of the licensed institution to the group level, subject to appropriate modifications. In the context of financial groups engaged predominantly in banking activities, this will involve group-wide compliance with existing bank-level regulatory requirements relating to

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single counterparty exposures, and holdings of immovable properties and investment in shares, interest-in-shares and collective investment schemes. For greater clarity, non-bank entities within a financial group will not be required to comply with regulatory limits specified for the financial group at the entity level provided that the group as a whole is compliant. Similarly, the prudential investment limits and limits on exposures to single counterparties within the Risk-Based Capital Framework for insurers and takaful operators will be extended with modifications to financial groups engaged predominantly in insurance/takaful activities.

- 6.3. Prudential requirements on outsourcing which aim to ensure that material outsourcing arrangements by licensed institutions are subject to appropriate due diligence, approval and on-going monitoring will also be extended to the apex entity of financial groups to address the risk arising from outsourcing activities carried out by the apex entity or any other group member for or on behalf of licensed institutions under outsourcing arrangements.
- 6.4. The apex entity will also be expected to ensure the effective monitoring, control and reporting of intra-group transactions and exposures. These requirements are intended to ensure that intra-group relationships and arrangements are carried out on an arms' length basis while also aiming to manage contagion risk.

## **7. Supervision**

- 7.1. Supervisory activities will be aimed at developing a holistic view of a financial group's financial condition and risk profile, and undertaking pre-emptive actions to stem any risk that will affect the safety and soundness of licensed institutions. This will involve identifying material risks or areas of concern associated with the activities of the financial holding company or material entities within the financial group and assessing the adequacy of group-level

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oversight and risk management control functions. This in turn will inform the Bank's assessment of the financial group's capital adequacy. In developing a risk assessment of a financial group, the Bank will take into account the legal and operational structure of the group (including the inter-relationships and dependencies across entities), as well as the degree of reliance on centralised risk management and other control processes. Going forward, the Bank will also look to apply supervisory requirements relating to resolution and recovery planning for licensed institutions to take into consideration the relationships and interdependencies within the financial group.

- 7.2. To support the effective supervisory oversight of financial groups, the FSA and IFSA provide for the Bank to:
- i. require a licensed institution or financial holding company, or any of its associate corporation or related corporation, to submit documents or information to the Bank<sup>29</sup>;
  - ii. examine the business affairs of a licensed institution and financial holding company, and any of its related corporations<sup>30</sup>;
  - iii. issue directions of compliance to a licensed institution<sup>31</sup>, or a financial holding company and its subsidiaries<sup>32</sup>; and
  - iv. take any enforcement action with respect to any breach or contravention by a licensed institution<sup>33</sup>, or financial holding company and its subsidiaries.
- 7.3. The Bank's approach to conducting supervisory activities will be risk-based, consistent with the approach presently adopted for licensed institutions. This approach will be underpinned by a process of early identification of risks and a system for progressively escalating the intensity of supervisory scrutiny and intervention. Under this system, the intensity of supervisory actions and

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<sup>29</sup> Section 143 of the FSA and section 155 of the IFSA.

<sup>30</sup> Section 147 of the FSA and section 159 of the IFSA.

<sup>31</sup> Section 156 of the FSA and section 168 of the IFSA.

<sup>32</sup> Section 116 of the FSA and section 128 of the IFSA.

<sup>33</sup> Part XV of the FSA and Part XVI of the IFSA.

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expectations placed on financial groups will vary to reflect differences in the risk profiles of individual financial groups.

- 7.4. As the activities of many financial groups span across borders and product markets, other authorities are also likely to be responsible for regulating or supervising certain entities or activities carried out within the financial group. The Bank intends to leverage on the cooperation and coordination arrangements with other regulatory authorities, both domestic and overseas, in the supervision of financial groups to facilitate timely information flows and effective supervisory responses or interventions, while also minimising duplicative supervisory efforts<sup>34</sup>. The sharing of information will allow a more comprehensive and accurate assessment of the financial performance and risk profile of the financial group.

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<sup>34</sup> For this purpose, the Bank has entered into various cooperation and coordination arrangements with other authorities. For example, the Memorandum of Understanding with the Securities Commission Malaysia sets out the roles and responsibilities of both authorities in the conduct of examinations of affiliates of licensed institutions which carry out regulated activities or provide capital market services as defined under the Capital Markets and Services Act 2007.