

Safeguarding the stability
of the financial system





responsive

responsible

4.1 The regulatory and
supervisory regime



4.2 Raising the standards of governance
and risk management



4.3 Regulation and greater regional
and international integration



A regulatory and supervisory regime that effectively maintains the stability of the financial system and soundness of financial institutions is necessary for sustainable growth and the orderly development of the financial sector.

Significant attention has been directed over the recent decade towards strengthening the effectiveness of the regulatory regime, in line with leading standards and practices, and providing an enhanced focus on governance practices and risk management.

The implementation of the Basel II capital adequacy rules for banking institutions in 2008 and the Risk-Based Capital Framework for insurers in 2009 have aligned regulatory requirements to the specific risk profiles and circumstances of individual financial institutions.

Strengthened corporate governance, risk management and disclosure standards have engendered prudent risk taking, while a risk-based approach to supervision and a pre-emptive intervention framework have supported comprehensive risk assessments and mitigation of risks to ensure the soundness and stability of financial institutions and the financial system. Pre-emptive responses to address risks in the financial system have ensured continued confidence and have minimised any disruption to the financial intermediation process during the recent global financial crisis. The enactment of the Central Bank of Malaysia Act 2009 has further reinforced the foundations for financial stability in Malaysia by enabling the Bank to respond more effectively to potential threats to the stability of the financial system.

Going forward, the regulatory and supervisory regime will continue to focus on safeguarding the stability of the overall financial system, including key market infrastructure; further strengthening the resilience of individual financial intermediaries; sustaining the Bank's ability to effectively regulate and supervise financial institutions on an ongoing basis; and promoting responsible and fair dealings towards financial consumers with due regard to financial stability. In doing so, key trends affecting the financial landscape will need to be taken into consideration, including:

- The increasing size and complexity of financial institutions, with higher levels of financial innovation;
- Continued evolution of financial institutions towards financial conglomeration;
- A more competitive and vibrant operating environment;
- A greater role of development financial institutions (DFIs) in financial inclusion;

- The growing significance of Islamic finance and its trend toward greater internationalisation; and
- The greater diversity of players in the Malaysian financial system, with cross-border linkages, a significant overseas presence of Malaysian financial institutions and greater participation of foreign financial institutions in Malaysia.

The recommendations will therefore focus on ensuring the continued effectiveness of the regulatory and supervisory regime that includes:

- Ensuring that potential risks to financial stability in the new financial landscape continue to be addressed through timely and appropriate policy measures;
- Raising the standards of corporate governance, risk management and control functions; and
- Establishing a regulatory and supervisory environment appropriate for a more regionally- and internationally-connected financial sector.



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4.1

the regulatory and supervisory regime

The regulatory and supervisory regime, including institutional arrangements, will be further developed to address potential risks to financial stability that may emerge from the evolving financial landscape. This will involve enhancing the legislative framework to promote a consistent approach to regulation and supervision across the financial sector; support a more risk-based approach to regulation and supervision; strengthen the Bank's capacity to manage risks associated with financial intermediation activities that occur outside the banking system (such as non-bank credit and financial intermediation activities); and provide enhanced powers for the Bank to take timely intervention actions



to deal effectively with vulnerable institutions in the interest of depositors, insurance policyholders and takaful participants.

Recommendation 4.1.1

Enact a comprehensive legislative framework for the conventional and Islamic financial systems respectively. The proposed legislation will reinforce a sound, transparent, and accountable system for effective regulation and supervision that is consolidated across the banking, insurance, takaful, financial intermediary and payment system services sectors.

Recommendation 4.1.2

Review regulations on the ownership structures of licensed financial institutions to encourage the participation and long-term commitment of strong institutional shareholders while preserving appropriate safeguards to promote the safety and soundness of financial institutions.

This includes:

- i. Allowing greater flexibility on the maximum permitted shareholdings by institutions and cross-shareholdings in financial institutions, with a view of allowing greater flexibility for shareholders that meet suitability requirements which are appropriate with the level of interest held in the financial institution. Such flexibility in shareholding

structures should not unduly amplify the inter-connectedness within the Malaysian financial system, create excessive industry concentration, or undermine competition in the financial sector.

- ii. Strengthening and enhancing the transparency of suitability criteria for significant controlling interests in financial institutions. This will include factors such as the ability of prospective shareholders to provide continuing financial support to the financial institution; their character, integrity, business record and experience; and whether their group structures or activities impede effective supervision and undermine financial stability. In addition, controllers will also be expected to demonstrate the soundness of their plans for the financial institution's business. To ensure the suitability of all persons exercising material influence over financial institutions, including those that may not necessarily hold direct equity positions, the notions of "interest" and "control" will also be further clarified and enhanced.

Recommendation 4.1.3

Strengthen the supervisory oversight over financial holding companies to avert risks to the safety and soundness of licensed financial institutions that may emanate from other entities within financial groups. Accordingly, financial holding companies will be subject to appropriate prudential

regulations with a greater level of supervisory oversight. This will be achieved mainly through:

- i. The formal authorisation of financial holding companies, which will include requirements for financial holding companies to meet relevant suitability criteria and demonstrate capabilities for ensuring prudent management over financial groups.
- ii. More transparent group structures and appropriate limits on the nature and scope of non-financially-related activities to ensure that depositors, insurance policyholders and takaful participants are not exposed to excessive risk and leverage.
- iii. Requirements for financial groups to comply with prudential standards, including on corporate governance, risk management, capital and liquidity to ensure effective risk management and soundness of operations of groups.
- iv. Appropriate powers for the Bank to examine, request information and implement supervisory interventions in financial groups.

A comprehensive legislative framework will be enacted to reinforce a sound, transparent and accountable system for effective regulation and supervision

Recommendation 4.1.4

Strengthen the institutional structure of financial institutions to provide adequate safeguards for depositors, insurance policyholders and takaful participants against contagion risks and excessive leverage. This will be achieved through:

- i. Implementing measures to ensure that retail deposits are not excessively leveraged by banking institutions in high-risk and complex activities. This includes requirements for high-risk activities to be conducted out of investment banking or specialised entities, along with other safeguards to maintain effective ring-fencing of retail deposits such as limitations or prudential requirements governing intra-group transactions and the sharing of operational infrastructure.
- ii. Requiring life and general businesses of insurers, and family and general business of takaful operators to be carried out under separate entities due to the different risk characteristics and nature of these businesses. Transition arrangements will be put in place to allow for an orderly segregation of businesses by existing composite insurers and takaful operators.

Recommendation 4.1.5

Promote the long-term sustainability and enhanced capacity of DFIs in support of their mandates. This will include:

- i. Enhancing the risk-sharing and accountability arrangements between the DFIs and the Government.
- ii. Introducing specific measures to further strengthen the corporate governance and risk management of DFIs so as to secure their self-sufficiency in funding and capital.

Recommendation 4.1.6

Implement the Basel III reform package to promote a more resilient Malaysian banking system. The standards will be implemented in Malaysia in phases, beginning 2013 until 2019, in line with the globally-agreed implementation timeline. This will include:

- i. Raising the quality of capital held by banking institutions, while also creating incentives for banking institutions to build up capital buffers that can be drawn down in times of stress. The enhancements to the capital standards will also consider the risk profile of banking institutions and the nature of their operations including cross-border activities and investments, as well as the offering or trading of exotic products.
- ii. Strengthening the liquidity standards of banking institutions by enhancing the existing liquidity framework in Malaysia, while also introducing incentives for banking institutions to tap stable long-term funding.

Implementation of the global standards will also carefully consider the operating environment in order to avoid unintended consequences. This will also include addressing structural issues such as the dominant role of institutional funds in mobilising household savings and the limited availability of high-quality liquid assets, particularly those which are Shariah-compliant. In overcoming these implementation challenges, the Bank will also encourage the development of solutions by the industry and cooperate with other agencies to formulate an appropriate regulatory framework for new instruments that will support banking institutions' compliance with the new standards.

Recommendation 4.1.7

Strengthen the regulatory and supervisory framework of the Labuan International Business and Financial Centre (IBFC) in line with international standards and best practices. This includes:

- i. Enhancing the capital standards for Labuan financial institutions in tandem with their growing sophistication and the development of other established financial centres. A risk-based capital model will be implemented for Labuan banking, and insurance and takaful sectors. The minimum statutory and paid-up capital of Labuan financial institutions will also be progressively increased.
- ii. Strengthening corporate governance and risk management practices of Labuan financial

institutions and other service providers with a focus on strengthening the oversight functions of financial institutions, and promoting sound management of credit, market, operational, liquidity and other risks.

Recommendation 4.1.8

Develop a framework for monitoring and managing risks arising from entities and activities taking place outside the directly supervised financial system. This will include:

- i. Enhancing data collection and surveillance of such entities and activities, particularly those of systemic importance.
- ii. Implementing appropriate regulatory responses to pre-emptively manage emerging risks. Where relevant, these will be employed in coordination with other authorities.

Recommendation 4.1.9

Enhance the institutional arrangements for effective and orderly resolution of distressed financial institutions through enhancing the role of the Malaysia Deposit Insurance Corporation (PIDM) as a resolution authority for dealing in an orderly manner with large, non-viable financial institutions in Malaysia that can affect financial stability. Recognising the expertise and capabilities being developed within PIDM to undertake the resolution of member institutions, PIDM is well positioned to facilitate the resolution

of a wider range of financial institutions in Malaysia including non-member institutions. This will be supported by appropriate accountability and financial arrangements to ensure the effective coordination between the Bank and PIDM as well as with other relevant authorities within and outside Malaysia.

Recommendation 4.1.10

Enhance the framework for financial crime prevention and investigation to preserve the integrity of the financial system. This takes into consideration the increasing sophistication of the nature and methods for perpetrating financial crimes, which necessitates more coordinated mechanisms for effective prevention, investigation and prosecution of financial crimes. In the near term, existing inter-agency coordination mechanisms will be enhanced with a view to consider more fundamental reforms to the institutional and legal framework to address financial crimes in the future. Given the more regionally- and internationally-connected financial sector moving forward, particular focus will also be directed at strengthening arrangements for cross-border collaboration in financial crime investigation.



Stock Exchange
Composite Stock Price Index and Equity Trading Value



Daily Equity Trading Frequency



4.2

raising the standards of governance and risk management

The increased size and complexity of the financial services industry in the emerging landscape will require standards of governance and risk management in financial institutions, as well as the role of market discipline, to be further strengthened to ensure effective oversight and prudent management of risks.

Recommendation 4.2.1

Strengthen the corporate governance of financial institutions and the role of market discipline in ensuring effective oversight over financial institutions.

Specific measures that will be pursued include:

- i. Requiring disclosures of periodic audits of corporate governance and Shariah governance so that shareholders and other stakeholders better understand whether disclosed governance policies and procedures are reflected in actual practice.
- ii. Codifying in law the functions of boards and responsibilities of individual directors, with emphasis on the need for directors to give due regard to the interest of depositors, insurance policyholders and takaful participants.
- iii. Supporting the development of a pool of independent directors to facilitate board succession and renewal. The pool, which will be established under the Financial Institutions Directors' Education (FIDE) Programme within the ICLIF Leadership and Governance Centre, will be developed through a systematic process of identifying, training and profiling potential candidates for new appointments in financial institutions.
- iv. Elevating the role of company secretaries that support the effective functioning of boards, including improving board interactions with management. For this purpose, the roles and responsibilities of company secretaries in financial institutions will be more clearly defined, and suitability criteria introduced to ensure that company secretaries have the necessary skills, competencies and experience to perform their duties and responsibilities effectively.
- v. Continue developing a suitable complement of education programmes for directors of financial institutions under the FIDE initiative.

Recommendation 4.2.2

Raise the standards of risk management and internal control functions across the financial sector in line with developments in the financial services industry. This will include:

- i. Enhancing risk management standards to address new and potential risks which may emerge from evolving industry practices and changes in the operating environment, including the expansion of market-based financial activities and instruments; the greater interdependencies arising from shared functions and services within financial groups; the more dynamic pricing of insurance and takaful products and more liberalised rules on expense management for insurers.
- ii. Requiring insurers and takaful operators to be served by independent and dedicated heads of risk and observe higher standards for risk management systems and processes, in line with their growing significance and importance in the financial sector. The role of actuaries and their interactions with key control functions will also be reviewed, with further clarification on the roles of actuaries in life insurers and family takaful operators, and a more prominent role for actuaries in general insurers and general takaful operators.
- iii. Introducing specific risk management standards for microlenders to ensure sustainable practices and that institutional safety and soundness

Corporate governance of financial institutions and the role of market discipline will be further strengthened to ensure effective oversight of financial institutions and prudent management of risks

is maintained, while also avoiding the emergence of predatory lending practices as financial inclusion further deepens in Malaysia.

Recommendation 4.2.3

Strengthen the foundations for a sound risk culture in the financial sector. A strong risk culture that promotes prudent risk taking and the long-term viability of financial institutions will become more important in the future financial landscape which is expected to be more diverse and competitive. This will be advanced through:

- i. Implementing measures to promote more risk-aligned executive compensation.
- ii. Developing codes and practices, and training programmes that support a sound risk culture.



| Country | Value 1 | Value 2 | Value 3 |
|-------------|---------|---------|---------|
| SINGAPORE | 46.72 | 46.97 | 46.99 |
| HONG KONG | 60.00 | 60.00 | 70.00 |
| AUSTRALIA | 0.207 | 0.201 | 0.207 |
| NEW ZEALAND | 22.00 | 22.00 | 22.00 |
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4.3

regulation and greater regional and international integration

The integration of the Malaysian financial system with the global financial system will further intensify as it plays a greater role in the intermediation of cross-border funds. Accordingly, the promotion of a regulatory and supervisory environment that is appropriate for a more regionally- and internationally-connected financial sector will be a key priority moving forward.



Home-host coordination arrangements, particularly with central banks and supervisory authorities within the region, will be strengthened to ensure the orderly expansion of Malaysian financial institutions overseas, and the entry of new foreign financial institutions in the domestic financial sector, as well as in the Labuan IBFC. These will seek to ensure that cross-border financial linkages foster regional growth in a manner that does not propagate systemic risk across borders.

Recommendation 4.3.1

Collaborate with other central banks and supervisory authorities to safeguard the stability of a regionally- and internationally-connected financial sector.

This will include:

- i. Achieving greater consistency in the principles of regulation and supervision across jurisdictions within the region. Strategic collaboration and cooperation initiatives will be pursued to build capacity and support the raising of standards across jurisdictions, with the view of promoting greater harmonisation of principles and mutual recognition of standards in the long run.
- ii. Establishing channels for the timely exchange of information between supervisory authorities to support the effective supervision of cross-border institutions, financial system surveillance, and crisis prevention, management and resolution. This includes the establishment and more active role of supervisory colleges for the supervision of regionally- and internationally-active financial institutions.
- iii. Strengthening liquidity safety nets to support more efficient cross-border provision of liquidity to markets and institutions in times of stress through bilateral and multilateral arrangements, which include the implementation of cross-border collateral and currency swap arrangements with other central banks within the region.

Recommendation 4.3.2

Participate in greater cross-border arrangements and supervisory cooperation to support the orderly development of an international Islamic finance industry.

This will include:

- i. Accelerating the development of a more robust infrastructure to support more efficient liquidity management.
- ii. Implementing prudential standards, risk management and Shariah governance practices.

These efforts will be pursued by leveraging on existing bilateral and multilateral initiatives within the region, including ASEAN, ASEAN+3 and the Executives' Meeting of East Asia-Pacific (EMEAP) Central Banks, as well as through international Islamic financial organisations such as the Islamic Financial Services Board (IFSB).

The Bank will seek to promote a regulatory and supervisory environment that ensures the orderly expansion of Malaysian financial institutions overseas and the entry of new foreign financial institutions into Malaysia

The immediate to medium term focus will be on efforts to reinforce the foundations for effective regulation and supervision, particularly with respect to strengthening the preconditions and creating an enabling environment to support the implementation of various recommendations under the Blueprint. This will include making necessary enhancements to the legislative framework, strengthening supervisory capacity, as well as enhancing coordination arrangements with other supervisory authorities within and outside Malaysia. Meanwhile, more fundamental reforms and enhancements that will be necessary to safeguard financial stability in response to the evolving financial landscape will be implemented in the medium to longer term. Attention will also be directed at continuously raising the standards of corporate governance, risk management and control functions.

