

Glossary

AML/CFT	Anti-Money Laundering/Counter Financing of Terrorism
AMLTF A	Anti-Money Laundering and Anti-Terrorism Financing Act 2001
BAFIA	Banking and Financial Institutions Act 1989
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles
BNM	Bank Negara Malaysia
CBA	Central Bank of Malaysia Act 2009
CPs	Core Principles
FRS	Financial Reporting Standards
FSA	Financial Services Act
FSAP	Financial Sector Assessment Program
FSPSR	Financial Systems and Payment Systems Report
IASB	International Accounting Standards Board
IBA	Islamic Banking Act 1983
ICAAP	Internal Capital Adequacy Assessment Program
IFRS	International Financial Reporting Standards
IIP	Individual Impairment Provisioning
IRB	Internal Rating Based
IRR	Interest Rate Risk
ELA	Emergency Liquidity Assistance
MASB	Malaysian Accounting Standards Board
MoU's	Memorandum of Understanding
NPLs	Non-Performing Loans
PIDM	Malaysian Deposit Insurance Corporation
RM	Relationship Manager
ROSC	Report on Observance of Standards and Codes
SRU	Specialist Risk Unit
SuRF	Supervisory Risk Based Framework

I. SUMMARY, KEY FINDINGS AND RECOMMENDATIONS

A. Summary

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

2. **BNM supervisors are guided and assisted by a generally well articulated set of risk management and internal control expectations, specified higher than international minimum capital requirements, a comprehensive liquidity risk framework, and effective coordination and information sharing with foreign supervisory authorities.** While some improvements (as detailed below) can be made, BNM has a generally appropriate array of guidelines and supervisory expectations covering overall risk management and most of the individual risk areas, as well as internal audit, compliance, and control functions. The BNM's capital framework is generally speaking in line with, and in many instances stricter than, international standards, although not covering financial holding companies and with some minor differences from the international standards. The liquidity framework is a multi-level approach to ensuring good liquidity in normal and high stress times (also not applicable to financial holding companies). BNM has an impressive network of formal and informal coordination and information sharing arrangements with foreign supervisors, and has been active in hosting and attending supervisory colleges and in conducting its own overseas examinations.

3. **Despite this strong performance, and as suggested above, a clear gap exists in the application of the supervision and regulation regime to financial holding companies.** Six of the eight large domestic banking groups have parent financial holding companies (FHCs), and the current legislative framework does not by its terms apply to those firms on a parent only or consolidated basis. Many of the affiliates of the bank are regulated by the BNM, but

some (such as asset managers) are not. The BNM has been creative by imposing conditions on the FHCs incident to approval of their investments in their banks, covering the nomination of their directors and CEO, acquisitions of shares of other companies, the issuance of capital instruments, and more generally complying with BNM guidelines. BNM has also used legislative authorities applicable to affiliates of banks to apply reporting and examination requirements to the FHC and its subsidiaries. Through these means, the BNM has been able to significantly reduce the existing gap, but not to completely eliminate it. No consolidated capital ratios apply to the FHCs; the liquidity framework does not apply on a consolidated basis; and stress testing expectations are not generally applied on a consolidated basis. As noted below, a proposed legislative change would address many of these issues.

4. **Some improvement opportunities exist in the regulatory framework, as more detailed regulation would be useful on interest rate risk in the banking book, credit concentrations, country risk, operational risk and in the requirement for banking institutions to have a separate, independent risk unit.** IRRBB and operational risk management requirements are generally in place and adhered to, but the release of more detailed regulation and supervisory expectations is currently underway. The BNM is planning to strengthen its regime for credit concentrations. The full implementation of Pillar 2 will also further strengthen the oversight of IRRBB and credit concentration risk. While country risk appears to be properly identified, assessed and reported to the BNM, more rigorous and comprehensive regulation should be considered. Although all of the domestic banking groups currently have independent risk units, there is no regulatory requirement to have them.

5. **Improvements should be made in the transparency of elements of BNM's supervisory expectations, its domestic coordination and information sharing arrangements and legal protection for staff.** BNM should increase the transparency of the criteria it applies for new licenses and for acquisitions. The BNM will further enhance transparency by wider public consultation on proposed policy measures in accordance with the Policy Development Framework. Feedback from market participants reflected a need for clearer communication of external auditors' supervisory expectations to banks, particularly in case these go beyond the usual audit procedures. Hence, assessors recommend the BNM more clearly communicate to banks its supervisory expectations in case there are required additional procedures in addition to the normal audit procedures. BNM's MOU with the Securities Commission should be modified to make it much more directed to consolidated supervision, and an MOU with the Cooperatives Commission (SKM) should be negotiated. Finally, it should be clarified that legal protection for BNM's staff should not depend on the person's employment status at the time of the lawsuit; former employees should be explicitly included. Consideration should also be given to include a provision in law permitting the BNM to indemnify these persons for their legal costs in the event they are sued.

6. **BNM is to be commended for its thoughtful and comprehensive BCP self-assessment (self identifying many of the areas for improvement needed cited above) and its strong efforts to help draft legislative changes and to make administrative changes to address the areas of improvement revealed by the self assessment.** Moving forward, BNM is seeking enhanced legal powers under new financial services legislation to enable full application of supervision and regulation of FHCs (including the capital framework). The proposed new legislation, the Financial Services Act (FSA) will, at such time as it is enacted, further define the specific objectives of financial regulation and supervision by BNM as the supervisory authority for the banking sector. In addition to the existing power to initiate criminal processes, the proposed FSA will empower BNM to impose civil and administrative penalties in the event of non compliance with legal provisions. BNM is also in the process of addressing gaps in its regulatory framework. The assessors recommend taking this opportunity to introduce more clarity on what regulatory requirements “must” be observed rather than “should” be met.

7. **The increasing sophistication of Malaysian banks’ risk management processes and the ongoing implementation of complex regulatory approaches (Basel II Pillar II and ICAAP) will put increased demands on staffing.** BNM currently has a relatively small cadre of specialized risk personnel in the SRU, who, in addition to performing model reviews, only occasionally carry out on-site visits to respond to specific request from relationship managers for technical assistance. As BNM moves forward with implementing the advanced approaches, including dealing in the coming period with recovery and resolution planning, the need for specialized risk personnel will increase overall, and the value they would contribute in making sure banking organizations implement the changes effectively, argues that more of their time be spent in the field in carrying out on-site reviews and direct engagement with banking institutions. This practice could be integrated gradually in the supervision framework, for example by requiring the participation of a risk specialist as the risk profile of the banking institution increases.

8. **There are some broad policy issues on the relationship between BNM and MOF, and between BNM and the Malaysia Deposit Insurance Corporation (PIDM) that should be reviewed.** The assessors found some instances in the legal framework where the Minister could interfere with BNM’s independence. For example, Section 70 in BAFIA allow the Minister at any time to direct the Bank to make an examination of the books or other documents, accounts and transactions of any licensed institution if he has certain suspicions with regard to a banking institution. Other examples include the use of the word “bank”, “banking” or any derivatives of this word by companies with the explicit approval of the Minister. Furthermore, Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, but only with the concurrence of the Minister remove and/or appoint new officers and directors. In practice, however, the assessors have not come across evidence of Government interference which would seriously compromise the independence of the BNM and note that the proposed FSA seeks to provide for greater independence in

supervisory decisions by BNM. A new Strategic Alliance between BNM and PIDM was agreed while the BCP review was taking place; how effective the arrangement is should be reviewed over time to ensure that when Malaysia may need to deal with a problem bank, the coordination is effective. How the assessment of the viability of an institution is to be made (and how transparent the criteria should be) and how the framework could be applied to FHCs are among the major policy issues to be considered.

B. Introduction

9. **This assessment of the current state of compliance with the BCPs in Malaysia has been undertaken** as part of a joint IMF-World Bank Report on the Observance of Standards and Codes (ROSC) mission.¹ The assessment was conducted from 4 April till 20 April 2012. It reflects the banking supervision practices of the Bank Negara Malaysia (BNM) as of the end of March 2012 for the supervision of commercial banks.

C. Information and Methodology used for the Assessment

10. **The assessment is based on several sources:** (i) a detailed and comprehensive self-assessment prepared by the BNM ; (ii) detailed interviews with the BNM staff; (iii) review of laws, regulations, and other documentation on the supervisory framework and on the structure and development of the Malaysia financial sector; and (iv) meetings with individual banks, the banking association and an external auditor.

11. **The assessment was performed in accordance with the guidelines set out in the Core Principles (CPs) Methodology.**² It assessed compliance with both the “essential” and the “additional” criteria, but the ratings assigned were based on compliance with the “essential” criteria only. The Methodology requires that the assessment be based on the legal and other documentary evidence in combination with the work of the supervisory authority as well as its implementation in the banking sector. The assessment of compliance with the CPs is not, and is not intended to be, an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the CPs set minimum standards.

12. **This assessment is based solely on the laws, supervisory requirements, and practices that were in place at the time it was conducted.** However, where applicable the assessors made note of regulatory and supervisory initiatives which have yet to be completed

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

² Issued by the Basel Committee on Banking Supervision, October 2006.

or implemented. In this respect, the proposed adoption of the Financial Services Act will be a notable development which could remedy many of the areas for improvement highlighted by the assessors.

13. The assessment team enjoyed excellent cooperation with its counterparts and, within the time available to perform their work, reviewed all the information provided.

D. Institutional and Macro-prudential Setting, Market Structure Overview

14. The financial system—both banking and non-banking—is concentrated. The onshore banking sector—with assets of some 200 percent of GDP—comprises nearly 50 percent of financial sector assets (Islamic banks are around 20 percent of the banking sector) and Labuan OFC banks an additional 3.2 percent. The top 5 domestic banking groups comprise nearly 62 percent of total banking system assets. The banking sector’s asset quality remained healthy with steady improvement in gross NPL ratios from 3.6 percent in 2009 to 2.7 percent in 2011. Total provisions (general and specific) were 99.4 percent of NPLs in 2011; NPLs net of specific provisions stood at 1.8 percent in 2011, below the 5-year average of 2.3 percent. Banks remain well capitalized with system-wide risk-weighted capital ratio and core capital ratios at 15.6 percent and 13.6 percent respectively in 2011.

15. Non-bank credit intermediation is sizable, at some 90 percent of GDP. This is accounted for predominantly by the state-run Employee Provident Fund (33 percentage points, including substantial government bond holdings), insurance companies (15 percentage points), and DFIs (16 percentage points). The bond market has doubled over the past 10 years to Malaysian ringgit (RM) 851 billion as at November 2011. Some 40 percent of bonds are issued by the ‘private sector’; this includes government-linked companies that are counted in private sector (in official statistics, ‘public’ covers central government and the BNM only). The EPF and insurance companies invest the majority of their portfolios in the domestic bond market, in both government and private debt securities.

16. DFIs provide credit via direct lending to targeted sectors such as agriculture, SMEs, infrastructure, maritime, export-oriented sector, high-technology and capital-intensive industries. The asset quality of these institutions seems to have deteriorated from 2009 to 2010 with gross impairment ratio rising 2.3 percentage points to 9.0 percent, but provision coverage remained comfortable at 80 percent. They are well capitalized with Leverage Ratio (Total Shareholders’ Funds-to-Assets) of 13.9 percent in 2010. In addition, the DFIs’ gross impairment ratio reduced to 7.3 percent in 2011.

17. There is a small financial sector in Labuan. Entities operating in Labuan benefit from tax advantages (very low financial sector income tax, no stamp duty). As at end of 2011, there were 60 approved banks with 57 in operations. Of these, 25 percent of the banks are part of Malaysian financial groups, and are subject to consolidated supervision by BNM. Operations of these entities in Labuan are almost entirely back-office; customer relations, dealing operations, risk management and loan decisions are all handled from the respective

head-offices in Kuala Lumpur. In addition to banks, there are insurance entities, leasing companies and trust companies operating from Labuan. In recent times, reinsurance activities (including Islamic insurance, known as ‘takaful’) have grown with many Labuan-based reinsurers having a global scope of operations.

18. **The financial system seems adequately positioned to withstand spillovers from an escalation in global financial stress.** The more recent uncertainties emanating from the Eurozone debt crisis have resulted in a tightening of global USD liquidity; but the impact on local banks is manageable. A global liquidity squeeze would not be expected to create severe deleveraging pressures in Malaysia. Portfolio outflows associated with a sell-off in local bond and equity markets, as in 2008–09, would unlikely have systemic implications. Nevertheless, financial turbulence would affect growth through confidence and credit channels (and thus, indirectly, trade). Moreover, contagion from a hard landing in China’s economy, or from an escalation of the current Eurozone crisis, could be significant.

E. Preconditions for Effective Banking Supervision

Soundness and sustainability of macroeconomic policies

19. **Malaysia recovered strongly from the fallout from the global financial crisis, but growth has started to slow more recently.** Growth reached 7.2 percent in 2010, but momentum is beginning to ease against the backdrop of a weakening external environment. In particular, the growth of manufacturing exports has slowed, although commodity exports have remained resilient. Growth was 5.1 percent in 2011; latest IMF staff projections suggest it will slow to 4 percent in 2012. Inflation remains contained and the rapid post-crisis buildup in public debt has leveled off. Capital inflows, which had rebounded strongly after the Lehmans’ collapse in 2008, have been scaled back. Inflows were robust through H1 2011, led by bond inflows, which increased steadily since 2008. However, foreign investors subsequently scaled back their exposures, mainly in equity markets and BNM bills, prompting a depreciation of around 8 percent against the U.S. dollar since the beginning of August. The depreciation was less severe than in some other open Emerging Market economies in part owing to foreign exchange intervention. BNM only intervenes in the domestic foreign exchange market to prevent extreme movements in the Ringgit exchange rate, with no particular level for the Ringgit in mind. Overall, foreign investor holdings comprise some 21 percent of the domestic bond market and 23 percent of the equity market.

A well developed public infrastructure

20. **The legal framework in Malaysia is based on a common law legal system.** Law are enforced through a single structured judicial system consisting of superior and subordinate courts whose decisions are enforceable, with avenues for appeal consistent with common law systems.

21. **In addition to the court system, alternative mechanisms for resolving disputes and debts also exist that allow judicial resources to be conserved, while expediting case disposals.** These include:

- Arbitration, which is governed by the requirements of the Arbitration Act 1952, or the Kuala Lumpur Regional Center for Arbitration (KLRC) Rules which are modeled after the UNCITRAL Arbitration Rules of 1976, revised in 2010;
- The Financial Mediation Bureau (FMB), an independent body, helps settle disputes between consumers and financial service providers, including banking institutions. The FMB handles a wide scope of disputes at no cost to the consumer. Decisions are binding on the financial institution but not the consumer who may choose to have further recourse through the court system;
- The Corporate Debt Restructuring Committee (CDRC) which provides a platform for corporate borrowers and their creditors to work out feasible debt resolutions with the CDRC mediating between companies and their lenders;
- The Credit Counseling and Debt Management Agency allows individuals needing assistance in managing their personal debt to enroll in its Debt Management Program which facilitates the rescheduling or restructuring of such credit facilities.

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

23. **Public interest entities are required to report their accounts using Financial Reporting Standards set by the MASB, which is in compliance with IFRS both in terms of content and timing of implementation.** IFRS is directly transposed into Malaysian FRS, with the text changed only where absolutely necessary. Any changes made are done with the sole objective of enhancing the quality of reporting, and typically deal with only specific issues not dealt with in the IFRS by illustrating or providing additional clarifications for better understanding or making changes necessary to comply with local laws and regulations.

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

25. **The Malaysian Electronic Clearing Corporation, (MyClear), a wholly owned subsidiary of BNM, operates RENTAS (Real Time Electronics Transfer of Funds and**

Securities), a real time gross settlement system for interbank funds transfer, a securities settlement system and a scripless securities depository for all unlisted debt instruments.

Rentas is also linked with the USD Clearing House Automated Transfer System in Hong Kong to mitigate for settlement risk for Ringgit and USD FX transactions. The link allows the simultaneous settlement of Ringgit in Malaysia and USD in Hong Kong as well as settlement for USD denominated securities deposited with Rentas during Malaysian business hours.

26. **The credit information services industry in Malaysia consists of agencies from both the public and the private sector.** The Centralized Credit Reference Information System (CCRIS) is operated by BNM. It collects and disseminates credit information from and to participating financial institutions. The credit reports contain factual information, including outstanding loan obligations with no thresholds, conduct of accounts, and repayment behavior of the individual. No opinion is expressed about the information supplied in the report. Private sector credit reporting agencies include Credit Bureau Malaysia Sdn. Bhd. (CBM), RAM Credit Information Sdn. Bhd (RAMCI), Financial Information Services Sdn. Bhd (FIS) and CTOS Sdn. Bhd. Private sector credit agencies will be regulated from this year by the Registrar of Credit Reporting Agencies under the Credit Reporting Agencies Act 2010.

Effective market discipline

27. **As public interest entities, banking institutions in Malaysia are subject to Financial Reporting Standards (FRS) established by the Malaysian Accounting Standards Board which are in compliance with the IFRS.** Banking institutions are also subject to additional transparency and disclosure requirements established by BNM which include:

- The Guidelines on Financial Reporting to Banking Institutions which set out the minimum disclosure requirements relevant to users of financial statements to assess the nature and extent of the risks associated with the operations of banking institutions.
- Pillar 3 disclosure requirements under Basel II which provide additional transparency and disclosure on risk management practices and the capital adequacy of banking institutions. This includes quantitative and qualitative disclosures with respect to credit risk, operational risk, and interest rate in the banking book.

28. **Mechanisms for providing an appropriate level of systemic protection (or public safety net).**

Crisis management

29. **The Central Bank of Malaysia Act (CBA) empowers BNM with a broad range of powers to avert or reduce risks to financial stability.** These include intervention and resolution measures, including powers to reduce systemic risks that emanate from both regulated and non regulated entities and to stem institutional or market liquidity shocks. While efforts are underway to establish a structured and formal framework for crisis management, individual elements of the crisis management framework are already in place:

- BNM assumes responsibility for addressing financial stability concerns given its mandate, powers and responsibilities set forth in the CBA, and its role as the central bank and supervisory authority for banking and insurance sectors, and the payment system. Within BNM, these functions are led by the Financial Stability Committee (FSC), which serves as BNM's internal high level forum responsible for discussing risks to financial stability and deciding on the appropriate policy responses.
- The CBA empowers BNM to enter into arrangements with other supervisory authorities to coordinate financial stability measures. BNM engages with other regulatory authorities such as the Securities Commission Malaysia and the Malaysian Deposit Insurance Corporation (PIDM) on a regular basis and collaborates with these agencies particularly in the areas of surveillance and supervision to facilitate the timely implementation of pre-emptive responses to systemic risk.

Deposit insurance

30. **The PIDM is a statutory body established in 2005 under the PIDM Act 2005.** Under the Act, the PIDM is to administer and provide deposit insurance to protect depositors against the loss of part or all deposits as well as a takaful and insurance benefits system to protect owners of takaful certificates and insurance policies in the event of a failure of a member institution. The deposit insurance system provides coverage for conventional and Islamic deposits, for all type of depositors, whether business or individuals. The maximum limit of coverage is RM 250,000 per depositor per member institution (namely commercial and Islamic banks). This includes both the principal amount of a deposit and the interest/return. By law, all commercial banks under the Banking and Financial Institutions Act 1989 (BAFIA) and Islamic banks licensed under Islamic Banking Act 1983 (IBA) including foreign owned banking institutions are member institutions of PIDM. Member institutions to PIDM are subject to a differential premium system, whereby annual premium charged are linked to certain risk and financial parameters of members institutions, thus providing incentives for member institutions to adopt sound risk management practices.

Liquidity support

31. **BNM has at its disposal a broad range of tools to allow for the effective containment of institutional or market liquidity shocks to prevent such shocks from**

32. **threatening systemic stability.** In addition to the operational standing facility framework that allows banking institutions to obtain overnight liquidity from the BNM to satisfy temporary liquidity needs, BNM has broad powers to provide liquidity assistance to any financial institution through a broad range of instruments. BNM is also empowered to enter into arrangements with other central banks to provide liquidity assistance to subsidiaries or branches outside Malaysia of any financial institution established in Malaysia.

33. **The development of a more formal and structured emergency funding liquidity assistance framework that institutionalizes sound practices ensuring continued efficacy of the lender of last resort function of BNM and better aligned operational, governance and accountability mechanisms, in line with the new requirements under the CBA is underway.** These include strengthened internal arrangements for the coordination of viability assessments of institutions requiring liquidity support, more formalized operating procedures for the provision of liquidity support as well as predefined features of the lending arrangements (e.g., acceptable collateral, interest rates).

Box 1. Islamic Banking in Malaysia

Islamic banking refers to a system of banking that complies with Islamic law or Shariah law. Malaysia has recorded robust growth in Islamic banking assets. Total assets in the Islamic banking sector (including DFIs) increased by 23.8% to RM 434.6 billion to account for 22.4% of total banking system assets as at end-2011. In Malaysia, Islamic banking is mostly conducted through separately incorporated banks – the 16 Islamic banks include ten which are domestically owned and six which are foreign owned. Licensed banks or licensed investment banks are also given the flexibility to operate an Islamic banking window, subject to meeting applicable standards and guidelines to ensure that the Islamic banking window operations are fully Shariah compliant – to date there are three commercial Islamic banking windows and seven investment banking windows.

In a dual financial system in which conventional and Islamic financial products are offered in parallel, a critical aspect of the regulatory framework is the consistency of rules and regulations across both sectors to eliminate possibilities for regulatory arbitrage. At the same time, there is a need to reflect the differences in the nature of risk inherent in Islamic financial products and services.

The regulatory framework for Islamic banks encompasses standards which are equally applicable to commercial or investment banks and standards which are modified or distinct to cater for risks specific to Islamic banking business. Shariah requirements are observed in the formulation of these standards through active involvement of the Shariah unit and consultation with the Shariah Advisory Council on Islamic Finance established under the Central Bank of Malaysia Act 2009 (SAC) on any matters requiring ascertainment of Islamic law.

The supervisory approach and practices for Islamic banks at the BNM are very similar to commercial banks. The only major difference is that, in accordance with the risk based supervisory framework, an additional operational risk i.e. that of Shariah compliance, is assessed for Islamic banks. This risk is analyzed in two ways; first, as a compliance risk embedded in every significant activity, second as an overarching operational risk for the whole bank. To assist with the specific detailed aspects of the assessment, a team of Shariah officers including a Shariah compliance expert employed in the BNM Specialist Risk unit provides input on specific matters with recourse to the SAC on need basis.

From a legal perspective, the Islamic banks are governed by a separate Act namely the Islamic Banking Act 1983 (IBA). In some areas, the IBA provides less legislative authority than the more recent Banking and

Box 1. Islamic Banking in Malaysia (concluded)

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

For example

- The lack of explicit power for the BNM to revoke licenses for Islamic banks; The IBA does not have a provision that allows the MOF, on recommendation of the BNM, to revoke a license granted when BNM has been provided with false, misleading or inaccurate information in connection with the application or after the grant of a license. Instead BNM may rely on contravention of any provision of the IBA, more specifically the provision relating to submission of document or information to the Minister upon any license application, for revocation.
- Unlike BAFIA, there is no specific share ownership threshold driving the need for an application in the IBA, however by regulation BNM has imposed the same 5% threshold.
- The IBA does currently not require external auditors to report matters of material significance to the supervisor, for example failure to comply with the licensing criteria or breaches of banking or other laws or other matters which they believe are likely to be of material significance to the function of the supervisor.
- The lack of explicit power to obtain information from the holding companies of Islamic banks. Section 41 of IBA only allows the BNM to request information from subsidiaries. Hence, the BNM can currently not conduct any examinations of holding companies or require holding companies, controllers or significant owners or any group or related entities to provide information to BNM for supervisory purposes. In practice however, this legal gap does not impede sound supervision by the BNM as most Islamic banks are held directly by a regulated banking institution. That said, one Islamic bank is not part of a commercial banking group and is held by a holding company and the BNM is of the opinion that it has been able to obtain relevant information relating to the holding company from the Islamic banks.
- The lack of power for the BNM to access auditors' working papers. In practice however the BNM has not yet used this power for commercial banks.
- Where the law provides for certain decisions to be referred to the MOF, BAFIA explicitly provides that decisions by the MOF should be made upon the recommendations of BNM. The MOF is further required under the law to consider the interests of the public and the promotion of a sound financial system in reaching a decision. This is currently not explicitly available under the IBA.

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

F. Main Findings

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

34. Laws are in place and the role of BNM and other authorities is clearly defined.

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

35. The assessors found some instances in the legal framework where the Minister could interfere with BNM's independence.

In practice, however, the assessors have not come across evidence of de facto government or industry interference. It would provide greater legal certainty regarding the independence of the BNM if these provisions were removed and the independence of the BNM were formally grounded in the law.

36. Legal protection for bank supervisors is in place and as a matter of practice the employees costs of defending actions made while discharging their duties in good faith would be borne by the BNM.

Some enhancements could be made to the current arrangements. Ideally, the CBA should specifically state that the legal protection provided to the BNM employees is not limited in time (i.e. provides protection beyond the termination of appointment or employment). Also, at the minimum, it is necessary that protection against incurring the costs of defending the actions of supervisors is stated clearly and explicitly (at least at the level of internal procedures), including the financing of any expenses since the start of the legal proceedings.

37. BNM has a good framework for information sharing with foreign supervisors, but domestic information sharing arrangements could be improved.

The MOU with the SC should be expanded to cover more than the investment banks that the SC and BNM co-regulate (i.e. to include asset management companies), and provide for the SC to share information with BNM on entities supervised by them that are part of FHCs and for BNM to alert the SC on supervisory developments in the broader banking group that could affect those institutions regulated by the SC. Information sharing with the SKM could also be formalized. Finally, the BNM should consider entering into MOUs with countries of major new entrants (e.g., Japan).

CP 2-5 Licensing and structure

38. The Malaysian banking law appropriately defines and controls the business of banking, with Bank Negara strongly overseeing the evolution of the banking structure, with some areas of needed concurrence (e.g., license approval) from the Minister of

Finance. BNM has presented publicly long term plans for banking and financial structure that have guided ongoing decision-making—as the country responded to the Asian banking crisis of the 1990s by consolidating banks into the current eight large banking groups that dominate the domestic market, and as the country looks forward over the next decade. Since that consolidation, the structure has been kept relatively stable with no new licenses for conventional commercial banks granted from 1970 until 2009; consistent with the long run plan to encourage the development of the Islamic banking sector, a number of Islamic bank licenses have been granted since 2004. The licensing and acquisitions that have occurred in recent years have been reviewed by BNM to ensure they are appropriate from a safety and soundness viewpoint and contribute to the development of the Malaysian banking market. There has been, however, little public transparency on the criteria used, as BNM has chosen to share expectations only directly with the applicants. Improving transparency and ensuring that appropriate focus is given to shareholders of banks in addition to the applicant banks are areas where improvements can be made.

Prudential Regulation and Requirements (CPs 6-18)

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

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

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

That said, full implementation is required to further strengthen oversight of interest rate risk in the banking book and credit concentrations.

Methods of Ongoing Banking Supervision (BCP 19-21)

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

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

Accounting and disclosure (CP 22)

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

Corrective and Remedial Powers (CP 23)

45. **BNM has broad discretion in the range of remedial actions it can take to address problem situations, which it takes within a well designed early intervention program.**

BNM's Supervisory Intervention Guide sets out a clear set of steps to take if a bank's condition deteriorates and its risk increases, with BNM having the clear power to issue directives to banks to take appropriate remediation actions.

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

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

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

48. **BNM has a very well developed program of information exchange and supervisory cooperation with an appropriate set of foreign supervisors, although it could make some elements of information exchange globally and domestically more formal.** BNM has put in place an extensive set of MOUs and less formal information exchange mechanisms with a relevant set of international supervisors. In addition it has been active in hosting and participating in supervisory colleges and carrying out its own program of overseas examinations. It has also been in the forefront in offering training programs to other supervisors in the region. As a matter of good practice going forward, BNM should, in

licensing foreign banks subsidiaries, do a formal independent assessment of consolidated home country supervision and look to enter into MOUs with countries of the major new entrants. BNM's MOU with the Securities Commission should be modified to make it much more directed to consolidated supervision, and an MOU with the Cooperatives Commission should be negotiated.

II. DETAILED ASSESSMENT

Principle 1	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1)	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	<p>EC1 Section 5 of CBA provides for BNM's responsibility to regulate and supervise banks (i.e., commercial, investment and Islamic banks), with the objective to promote monetary and financial stability conducive to the sustainable growth of the Malaysian economy. The powers for BNM to regulate and supervise conventional and Islamic banks are provided under BAFIA and IBA respectively. In the case of investment banks, these entities are jointly regulated and supervised by BNM and the Securities Commission (SC). The specific areas of responsibility and cooperation of each authority are described in a MoU between both parties, whereby BNM focuses on prudential aspects of investment banking operations while SC is responsible for the market conduct aspects of investment banks. (see also CP 1.6). BNM is also the designated competent authority under the Anti Money Laundering and Anti terrorism financing Act (2001) See CP 18.</p> <p>The SC is the capital markets supervisor in Malaysia and is governed by the Securities Commission Act (1993), the Malaysian Deposit insurer or Perbadanan Insurans Deposit Malaysia provides deposit insurance for bank deposits as well as insurance products is governed by the Malaysia Deposit Insurance Corporation Act (2011). The Malaysia Cooperatives Societies Commission oversees the cooperative sector and is governed by the Malaysia Cooperative Societies Commission Act (2007).</p> <p>EC2 Parts VII, VIII and IX of BAFIA set the legislative requirements to be observed by banking institutions and provide BNM with the power to issue a broad range of binding prudential regulations (issued as guidelines or circulars) on banking institutions which further elaborates BNM's supervisory expectations. The BNM is also empowered under section 126 of BAFIA and to impose any other regulatory requirements to address issues of safety and soundness. For example, BNM has issued Guidelines on Introduction of New Products, Guidelines on Property Development and Property Investment Activities by Islamic Banks and Credit Card Guidelines. This provides BNM with the flexibility to</p>

	<p>respond effectively and quickly to changes in the banking industry. Additionally BNM publishes “Best practice” documents which, despite their title, also state that they contain mandatory requirements, highlighted in specific boxes.</p> <p>EC 3 The law provides considerable flexibility for BNM, through its general power to issue guidelines under s126 of BAFIA, to respond as necessary and in a timely manner to changing industry and regulatory practices. These guidelines are updated periodically to ensure their continued effectiveness and relevance with key changes reported in the Financial Stability and Payment Systems Report (FSPSR) every year. BAFIA are amended from time to time. These updates are commonly triggered by changing operating landscape or market developments or new regulatory initiatives to enhance the safety and soundness of the financial institutions and are focused on specific areas that require improvement. The last amendments to the BAFIA were in 2005 on the resolution of banks, when PIDM was established as the financial safety net and resolution authority for deposit insured banks.</p> <p>EC 4 BNM publishes annually the FSPSR which contains key information on the financial system and performance of the banking industry as well as BNM’s assessment of risk and issues in the Malaysian financial system. In addition, BNM also publishes the Monthly Statistical Bulletin and Quarterly Bulletin which provide selected statistics on the banking sector on a monthly and quarterly basis. These publications are available on BNM’s website.</p> <p>AC 1The BNM adopts a risk based approach to supervision. Under the Supervisory Risk Based Framework (SuRF), significant activities of individual banking institutions are reviewed, inherent risks associated with these activities as well as effectiveness of risk management control functions. See CP 19 and CP 20 for more information on the risk based supervision framework.</p>
Assessment	Compliant
Comments	<p>Laws are in place for banking and the role of BNM is clearly defined. Clear responsibilities and objectives for other authorities are also in place.</p> <p>The adoption of the draft FSA will further enhance the definition of the specific objectives of financial regulation and supervision by BNM as the supervisory authority for the banking sector.</p> <p>The BNM has issued the “Financial Sector Blueprint 2011-2020”, a strategic plan that lays out the future direction of the Malaysian financial system.</p> <p>The assessors recommend the BNM uses stronger language in its guidelines and recommendations, clearly stating that banks “must” observe the regulatory requirements instead of “should” observe the regulatory requirements. This will be addressed by the BNM’s Policy Development Framework which was rolled out for implementation on 17 May 2012.</p>
Principle 1(2)	Independence, accountability, and transparency. Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources and be accountable for the discharge of its duties.

Description	<p>EC1 BNM is established as a statutory body with its role and authority derived from CBA. The powers conferred to BNM under CBA are exercised by the Governor (or in the Governor's absence, the Deputy Governor). Section 3(1) of BAFIA provides for the Governor to perform the supervisory and regulatory functions under the Act and may authorize any other officer of BNM to carry out such functions (section 3(2)). BNM is vested with full authority to perform its regulatory and supervisory functions. Where the law provides for certain decisions to be referred to the MOF, BAFIA explicitly provides that decisions by the MOF should be made upon the recommendation of BNM. The MOF is further required under the law to consider the interests of the public and the promotion of a sound financial system in reaching a decision.</p> <p>Section 14 of CBA provides for the constitution and composition of the Board of Directors of BNM, who are responsible for the general administration of the affairs and business of BNM and the approval of the budget and operating plan. The oversight function of the Board is supported by Board Committees, including the Board Governance Committee, Board Audit Committee and Board Risk Committee. The functions of these committees are described in section 21 of CBA.</p> <p>Provisions relating to the appointment, reappointment, termination and disqualification of the Governor, Deputy Governor(s) and other directors of the Board are contained within part IV of CBA. The Governor and directors of the Board are appointed by the Yang di-Pertuan Agong (the King) while the Deputy Governors are appointed by the MOF. The services of the Governor, Deputy Governor or any other directors of the Board may only be terminated on the grounds set out in CBA. Since the establishment of BNM, no Governor, Deputy Governor or member of the Board has been removed from office.</p> <p>BNM has in place internal governance arrangements and procedures that support accountability and sound decision making for policies, supervision and resolutions. Certain actions require the approval of the Financial Stability Executive Committee, the majority of which are external members to BNM. The terms of reference have been published in the 2010 annual report.</p> <p>Some sections in the legal framework give powers to the Minister which have the potential to undermine the autonomy of the BNM, for example:</p> <ul style="list-style-type: none"> • Section 70 of BAFIA allow the Minister to direct the BNM at any time to make an examination of the books or other documents, accounts or transactions of any licensed institution and its offices inside and outside of Malaysia. • In accordance with Section 6 of BAFIA, the Minister has the authority to license and withdraw licenses from commercial banks on recommendation of the BNM • Section 15 of BAFIA allows companies to use the word “bank”, “banking” (...) or any derivatives of this word with the explicit approval of the Minister (see CP2). • Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, but only with the concurrence of the Minister remove and/or appoint new officers and directors; the BNM can also recommend to the Minister the revocation of a banking license. <p>In practice however, the BNM confirms that the Minister has never deviated from or attempted to influence the recommendations of the BNM. Section 70 of BAFIA has never</p>
-------------	---

	<p>been used.</p> <p>EC 2 BNM publishes the Financial Stability and Payment Systems report (FSPSR) which provides an account of BNM’s regulatory and supervisory activities for each year and developments in risks to financial stability. BNM is held accountable for the performance of its mandate in the following ways:</p> <ul style="list-style-type: none"> • Section 72 of CBA requires that BNM keeps the MOF informed on policies relating to its objectives; • BNM may also be requested to provide explanations on any policy issues to the Parliament (via the Public Accounts Committee of the Parliament); • Accountability to the Board (section 14 of CBA); and • Requirement to publish the Annual Report (section 13 of CBA). <p>In situations where there are differences in opinion between BNM and the MOF for policy issues relating to BNM’s statutory objectives, CBA details out the mechanism to resolve such differences through the Cabinet as well as the Parliament (section 72). No such situation has arisen since BNM’s establishment.</p> <p>EC3 BNM has created a pool of talent for various job levels through its staff profiling programs to ensure an adequate supply of quality resources to support its functions. Industry participants confirmed the BNM and its staff have established their credibility based on professionalism and integrity. BNM staff is subject to a Code of Conduct that sets out standards of conduct in areas relating to, among others, confidentiality, conflicts of interest and dealings with the banking industry. The assessors’ interactions and the feedback from industry and stakeholders on the professionalism, integrity and expertise were positive.</p> <p>EC4 BNM’s supervisory functions are self funded and resources are allocated to perform its functions in accordance with its statutory objectives. In 2011, 25 percent of the total budgeted operational expenditures was allocated to the regulatory and supervisory functions. In accordance with Section 7 of CBA, the BNM has full discretion to determine salaries, allowances and benefits for its staff. The remuneration and benefits package is comparable with market rates and is benchmarked to the market every three years. Turnover of staff in the supervision and regulation department is around 9%. The BNM states that it addresses turnover by employing a 30% buffer on top of minimum required staff. BNM has invested significantly in the strengthening of its supervisory capacity by offering various training programs and scholarships for its staff. BNM has the legal authority to appoint any person to assist in the performance of its functions, as provided under section 3 of BAFIA.</p> <p>AC 1 Section 15(4) CBA provides that the Governor shall be appointed for a term of five years, while the Deputy Governors shall each be appointed for a term of three years.</p>
Assessment	Largely compliant
Comments	<ul style="list-style-type: none"> • Transparency in the policy activities of the BNM should be increased. This will be achieved by the adoption of the new Policy Framework.

	<ul style="list-style-type: none"> • Governance arrangements (including operational procedures) and the roles/responsibilities of various functions within the BNM have yet to be disclosed to the public for clarity and accountability. • There are some instances in legal framework where the Minister could interfere with BNM’s independence. For example, Section 70 in BAFIA allow the Minister at any time to direct the Bank to make an examination of the books or other documents, accounts and transactions of any licensed institution if he has certain suspicions with regard to a banking institution. Also, Section 15 of BAFIA allows companies to use the word “bank”, “banking” (...) or any derivatives of this word with the explicit approval of the Minister. Furthermore, Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, but only with the concurrence of the Minister remove and/or appoint new officers and directors; the BNM can also recommend to the Minister the revocation of a banking license and approval of transfers of significant ownership. <p>In practice, however, the assessors have not come across evidence of Government interference which would seriously compromise the independence of the BNM.</p> <ul style="list-style-type: none"> • It would provide greater certainty regarding the independence of the BNM if these provisions were removed and the independence of the BNM were formally grounded in the law.
<p>Principle 1(3)</p>	<p>Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.</p>
<p>Description</p>	<p>EC 1 BAFIA provide that the granting and revocation of banking licenses are to be exercised by the MOF, based on the recommendations and conditions proposed by BNM. The laws also specify the circumstances under which the licenses may be revoked. Considerations taken in assessing licensing applications are detailed under Core Principle 3 on licensing criteria.</p> <p>EC 2 Within the BAFIA, there are substantive provisions that provide the BNM power to issue regulatory requirements on specific matters (such as the maintenance of capital funds, BAFIA section 37) which also carry specific criminal penalty provisions in the event of breaches.</p> <p>BAFIA also has the general power for the BNM to issue guidelines, circulars and notices as it considers appropriate (such as BAFIA section 126). The Courts have opined that guidelines and circulars issues by the BNM pursuant to the general power are legally binding on banking institutions. The assessors were provided with the two court decisions in this respect.</p> <p>Guidelines and circulars set out the BNM’s expectations regarding sound practice. In some instances the expectations are described as “best practice”. Despite its term, the “best practices” are minimum requirements that must be observed by financial institutions as well as evolving practices which allow for proportionality in the financial institution’s application of the guidelines. Over time, many of the best practices have now been established as expectations for all institutions and are consistently applied in supervisory assessments of financial institutions. Feedback from market participants confirmed that “best practices” are considered binding.</p>

	<p>The BNM consults with the banking industry and in some cases with other stakeholders, including relevant regulatory agencies on proposed policy measures and practical challenges or issues arising from implementation. Feedback from industry participants on the BNM's consultation processes was positive.</p> <p>EC 3 Section 43 of BAFIA empowers BNM to require banking institutions to submit to BNM information concerning the institution's assets and liabilities and any other statistics or reports that BNM may specify. BNM may also require a banking institution's offices operating outside of Malaysia to submit information relating to its operations. Section 1138 of BAFIA further provides BNM the power to obtain information from any licensed institution, scheduled institution or foreign institution or from any person engaged in the provision of finance for the purpose of exercising any of BNM's powers or for the performance of its duties. Section 113 also enables BNM to obtain information on related corporations to these institutions to facilitate the assessment and surveillance over banking groups.</p> <p>In addition, BNM is empowered under section 30 of CBA to obtain, in the interest of financial stability, information concerning any financial institution, participants of the financial markets or any person (that is not under BNM's regulatory purview) that may pose a risk to financial stability. This information may be obtained from the relevant supervisory authority or Government agency in Malaysia or directly if the entity is not under the oversight of any authority or Government agency. Section 40 of CBA also allows BNM to obtain information from any other supervisory authority outside of Malaysia if BNM considers it necessary for promoting financial stability, which allows BNM to undertake cross-border cooperation with other supervisors effectively. (See also EC 2 of CP 1(6) and EC 1 and 2 of CP25).</p>
Assessment	Compliant
Comments	<ul style="list-style-type: none"> • The BNM will further enhance transparency by wider public consultation on proposed policy measures in accordance with the Policy Development Framework. • For the sake of transparency, the BNM should align the terminology used in its regulations. Circulars, guidelines and best practices are generally considered binding for banks and there may not be any need to distinguish between them.
Principle 1(4)	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	<p>EC 1: Under Section 73 of BAFIA, BNM has the discretion to take a broad range of supervisory actions with a substantial degree of judgment. Among the criteria for taking such actions is whether the institution is operating in a manner that is detrimental to depositors' interests or the public interest, or whether the institution has contravened any provision of BAFIA or CBA.</p> <p>EC 2: Under Section 71 of BAFIA, BNM has full access to the books and records of supervised institutions, as well as to its officers and directors.</p> <p>EC 3: Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, and with the concurrence of the Minister of Finance (MOF) remove and/or</p>

	appoint new officers and directors; the BNM can also recommend to MOF the revocation of a banking license.
Assessment	Compliant
Comments	BNM has the authority to address compliance with laws and safety and soundness concerns through a broad grant of legislative authority.
Principle 1(5)	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>EC 1 Section 87 of CBA, section 114 of BAFIA provide protection for any BNM staff and any person lawfully acting on behalf of BNM and any person appointed pursuant to the CBA from lawsuits in respect of any actions or omissions in good faith for the purpose of performing their duties. The CBA further clarifies that the protection includes the Governor, the Deputy Governor and the other directors. The Legal representative of the BNM stated that the protection extends to staff after they leave the agency.</p> <p>EC 2 In practice, BNM assumes the legal cost for defending against lawsuits on its supervisors' actions provided that the BNM supervisors discharge their duties in good faith. There are however no precedents where the BNM has had to assume the legal costs of defense.</p>
Assessment	Compliant
Comments	<p>Staff and persons appointed by the BNM are covered by the statutory immunity clause for any action taken in good faith in pursuance of their duties.</p> <p>The assumption of the legal cost for defending against lawsuits faced by individual supervisor could be anchored in the law.</p> <p>The legal coverage should not depend on the person's employment status at the time of the lawsuit; former employees should be explicitly included. Further, consideration should be given to include a provision permitting the BNM to indemnify these persons for their legal costs in the event they are sued.</p>
Principle 1(6)	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>EC 1: Under Section 40(1) of the CBA, BNM has the authority to enter into cooperation and information sharing arrangements with other domestic authorities for purposes of financial stability. It has entered into MOUs with the Securities Commission (SC)—one that is very broad and one that is very narrow in scope (covering the investment banks for which BNM and SC share regulatory authority). The MOUs do not provide for the SC sharing information with BNM regarding other entities (e.g., asset management companies) that are supervised by the SC and can be part of Financial Holding Companies (FHCs) or other banking groups. The MOUs also do not provide for BNM alerting the SC to developments within the broader banking group that could affect the entities within the group that are supervised by the SC.</p> <p>BNM has periodic discussions with the Cooperatives Commission of Malaysia (SKM) but no formal information sharing arrangement with it. BNM has very recently entered into an updated Strategic Alliance Agreement (SAA) with the Malaysia Deposit Insurance Corporation (PIDM). BNM also cooperates with the Labuan Financial Services Authority, which is chaired by the BNM Governor; BNM supervises Labuan operations of Malaysian</p>

	<p>banks in the same way as operations in all other parts of Malaysia.</p> <p>EC 2: Also under Section 40(1) of the CBA, BNM can enter into cooperation and information sharing arrangements with foreign supervisory authorities. BNM has in fact entered into MOUs with authorities in four countries (Cambodia, Vietnam, China, and Indonesia). As discussed in CP 25, the formal and informal information sharing arrangements with foreign supervisors are working well. It would be useful for BNM to begin regularly entering into MOUs with countries of major new entrants (e.g., Japan); MOUs would be particularly important with those countries, which can only exchange information pursuant to formal agreements.</p> <p>EC 3: Under Section 86 of the CBA, officers and staff of BNM are obligated to maintain confidentiality of information in their possession. In sharing information pursuant to the arrangements with foreign supervisors described above, BNM elicits an undertaking for protecting the confidentiality of such information and the purposes which such information is to be used, as provided for in Section 40(2) of the CBA</p> <p>EC 4: Section 40(1) of the CBA provides discretion to BNM to provide information as it deems appropriate to other supervisors. Implicit in that grant of discretionary authority is the capacity to deny a request.</p>
<p>Assessment</p>	<p>Largely Compliant</p>
<p>Comments</p>	<p>BNM has a good framework for information sharing with foreign supervisors, but information sharing arrangements could be improved through:</p> <ul style="list-style-type: none"> • expanding the MOU with the SC to cover more than the investment banks that the SC and BNM co-regulate (i.e. to include asset management companies), and provide for the SC to share information with BNM on supervisory developments on entities it supervises and for BNM to alert the SC of supervisory developments in the broader banking group that could affect those institutions within the group regulated by the SC • more formalized information sharing with the SKM. • the BNM entering into MOUs with countries (e.g., Japan) of major new entrants.
<p>Principle 2</p>	<p>Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.</p>
<p>Description</p>	<p>EC 1: Section 2 of BAFIA defines bank as a person carrying on the “business of banking”, which in the same section is defined to include receiving deposits, paying or collecting checks, and provision of finance. Merchant banks are also defined in that Section to include persons engaging in receiving deposits, provision of finance, providing consultancy and advisory services, or making or managing investments.</p> <p>EC 2: Under Section 4(1) of BAFIA, all companies carrying on a commercial banking or merchant banking business are required to be licensed under Section 6(4) of BAFIA.</p> <p>EC 3: Under Section 15 of BAFIA, except with the written consent of the Minister of Finance, companies are prohibited from using the word “bank”, “banking”, “banking and finance company”, “deposit-taking company”, “merchant bank” or any derivatives of these words in any language capable of being construed as indicating the carrying on of</p>

	<p>such business.</p> <p>EC 4: Section 25 of BAFIA explicitly prohibits any person from taking deposits unless it has a license to do so. In addition to banks, there are development financial institutions (six of which are supervised by BNM), cooperatives and building societies (supervised by SKM), and special purpose developmental institutions (which operate under their relevant statutes) which can be licensed to take deposits.</p> <p>EC 5: Section 18 of BAFIA and Section 13 of IBA require that a list of all licensed banking institutions (domestic or foreign) established in Malaysia be published annually in a Gazette.</p>
Assessment	Compliant
Comments	The existing legal and regulatory provisions appropriately define and control the business of banking, including, in particular, deposit-taking. There are some deposit-taking companies not regulated by BNM.
Principle 3	Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home-country supervisor should be obtained.
Description	<p>EC 1: Under Section 6 of BAFIA, applications for licenses must be submitted to BNM, which evaluates them under the licensing criteria and submits recommendations to the MOF for action. The MOF can approve or reject the application only upon receiving BNM's recommendation. BNM (and MOF) have been very conservative in the granting of new licenses over the past forty years—some Islamic banks were approved after 2004 and some (principally) foreign banks were offered the opportunity to apply for licenses in 2009 with some approvals granted.</p> <p>EC 2: The Second Schedule of BAFIA provides the minimum criteria that must be met to be granted a banking license, and also provides for BNM, with the concurrence of the Minister, to prescribe any further criteria. As noted in EC 1, BNM has been conservative in the granting of new licenses, effectively adding a requirement that the license would contribute to Malaysia's developmental objectives, as was made known to the prospective applicants in 2009. In its Financial Sector Blueprint 2011–2020, this theme is echoed.</p> <p>EC 3: According to the internal documents BNM shared with us, the licensing criteria applied included the evaluation of financial soundness and strength of the applicant, including the nature and sufficiency of significant shareholders, the integrity of the applicant, and the suitability of persons operating the bank in Malaysia. These are consistent with ongoing supervisory expectations. As noted above, an additional criterion has been the value proposition of how the license would contribute to Malaysia's developmental objectives.</p> <p>EC 4: Under Section 6(4) of BAFIA, the MOF has the authority to grant or deny any application on BNM's recommendation. BNM looks to ensure that the information provided is complete before making its recommendation.</p>

EC 5: Under Section 4(1) of BAFIA, all licensed banks are required to be locally incorporated subsidiaries in Malaysia; as such, such key structural elements as a physical presence in Malaysia, a dedicated Board of Directors, and senior management in Malaysia overseeing the day to day operations of the bank are required. During the licensing process, reviews of structure information of both the applicant and its broader group has takes place. The draft FSA includes explicitly in its licensing criteria a provision to assess whether the structure and degree of supervision of the overall group could hinder effective supervision.

EC 6: The applicant is required to disclose shareholders having 5 percent or more of its shares (directly, indirectly, or through beneficial ownership (given the definition in Section 6A of the Companies Act that applies)) or shareholders that otherwise can exert a controlling influence. There is some analysis of whether such shareholders could serve as a source of strength, but there are no current criteria explicitly covering an assessment on the nature and sufficiency of financial resources and integrity of the shareholder as will be required under the new legislation. There is also no requirement for major shareholders, including beneficial shareholders, to disclosure changes in their suitability.

EC 7: Section 14(1) of BAFIA stipulates that a license cannot be granted if the capital of the new bank is less than the prescribed minimum. Minimum amounts are set forth by regulation in Banking and Financial Institutions (Minimum Amount of Capital Funds) Order 2001, and IBA Gazette Order August 2008. The bank must continue to meet that minimum amount on an ongoing basis.

EC 8: BAFIA's Second Schedule provides the criteria under which BNM assesses whether a director, controller or manager (including a CEO) is fit and proper. It includes assessing the person's probity, competence, soundness of judgment, and diligence in fulfilling the responsibilities as a director or manager. It explicitly includes consideration of whether the person has been convicted of a criminal offense relating to dishonesty, fraud, or violence. It also directs BNM to assess whether past business practices were deceitful, oppressive, of otherwise improper, allowing BNM to consider past supervisory and regulatory considerations. The provisions however cover only the CEO among the senior management team. In the draft legislation, the licensing criteria will include explicitly whether the bank will be operated responsibly by persons with competence and experience suitable for involvement in the operation of a financial institution.

EC 9: In the licensing process, the applicant provides a business plan covering the first three years of intended operation. Included in the plan is a description of risk management systems and procedures, including oversight of functions to be outsourced and the corporate governance structure. The new legislation will more explicitly require assessing the soundness and feasibility of the business plan.

EC 10: An applicant is required to provide projections through pro forma financial statements and key financial ratios for the first three years of operations. Its evaluation of the projections in particular ensures that capital requirements will be met, with appropriate buffers available, particularly in the early years in the event of losses. More generally BNM reviews the financial strength of the applicant and principal shareholders.

EC 11: In applications by foreign banks, BNM contacts the home supervisor to provide a letter of non-objection and confirmation that it performs consolidated supervision over the applicant and its affiliates, including the Malaysian subsidiary. The BNM officials indicated to the assessors they do review past FSAPs of home countries to support review of how the applicant is supervised. Under the proposed changes to the banking

	<p>law, there will be a more explicit evaluation of the nature and degree of regulation and supervision applied by the home country supervisor.</p> <p>EC 12: Section 7(1) of BAFIA allows the MOF on the recommendation of BNM to revoke a license if BNM was provided with false, misleading, or inaccurate information in connection with the application or after the grant of the license.</p> <p>EC 13: In applications, BNM reviews the composition of the Board of Directors to ensure that there is appropriate diversity of background with knowledge and experience in a variety of disciplines such as finance, accounting, legal, business management, information technology, and investment management. On an ongoing basis, the Board's Nominating Committee is charged under BNM's Guidelines on Corporate Governance for Licensed Institutions with carrying out an annual review of the mix of skills, experience, and core competencies of the overall Board.</p> <p>AC 1: The assessment of the financial strength of an applicant includes consideration of the financial strength of its significant shareholders. BNM considers whether there are constraints on the parent and its shareholders to support the proposed business in Malaysia. A comfort letter is also requested. In the new legislation, the licensing criteria will more explicitly include the nature and sufficiency of financial resources of significant shareholders.</p> <p>AC 2: BNM monitors the compliance of a new bank with the conditions of its license approval. Failure to meet the conditions can result in the revocation of the license under Section 7(1) of BAFIA.</p>
<p>Assessment</p>	<p>Largely Compliant</p>
<p>Comments</p>	<p>BNM has a conservative program for the granting of new licenses, where in the exception of the explicit inviting of companies to apply for a stipulated set of new licenses (as occurred in 2009), no applications for conventional commercial banks have been considered in forty years. New legislation (FSA) would, at such time as it is enacted, deal with many of the limitations in the current approach, listed below, but in any event, going forward BNM should address the following:</p> <ul style="list-style-type: none"> • Reflecting the infrequency with which applications have been entertained, the degree of transparency in the criteria to be applied has been less than in other countries and should be improved. • The focus of the application review was most heavily on the immediate applicant, although some review was done of ultimate shareholders. The criteria should explicitly include an assessment on the nature and sufficiency of financial resources and the integrity of the ultimate shareholder. • In the case of foreign banks, there is no explicit independent evaluation of the nature and degree of consolidated regulation and supervision applied by the home country supervisor, as review is focused essentially on available FSAPs. • Criteria on the suitability of officers (covering more of the senior team than the CEO) and the achievability of business plans need to be more explicit; the new FSA will address these issues, and the BNM is also developing a key performance indicator framework to monitor the achievability of such business plans.
<p>Principle 4</p>	<p>Transfer of significant ownership. The supervisor has the power to review and reject</p>

	any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	<p>EC 1: Under Section 45 of BAFIA, the trigger to obtain approval for the acquisition or disposition of shares is set at 5 percent. Control is defined in Section 2 of BAFIA as a) interest of 50% of a bank's shares; b) power to appoint a majority of the directors of a bank; or c) power to make decisions in respect of the business or administration of a bank. Under Section 6A of the Companies Act, beneficial ownership of shares are included in these assessments.</p> <p>EC 2: Approval of the BNM is required for changes in the ownership, exercise of voting rights, or controlling interest, using the thresholds described in EC 1. The process followed by the BNM is a two-staged one, where prior to starting negotiations with a bank, a party must seek the approval of the BNM to determine whether there is reasonable likelihood of meeting the suitability criteria for shareholders of financial institutions; if there is, the second stage of formal application can begin. (This is provided for in a circular on "Negotiation for the Acquisition and Disposal of Interest in Shares of Licensed Institutions Regulated by Bank Negara Malaysia"; BNM asserted that the provisions of guidance are legally enforceable as confirmed in a judicial opinion provided to the assessors, and accepted by banking representatives).</p> <p>EC 3: Sections 45, 46, and 49 of BAFIA provide explicitly for BNM to recommend to MOF to approve or reject an application for a change in significant ownership, including beneficial ownership or controlling interest. The criteria are comparable to those used for approving new banks, as the broad criteria include whether the proposal is prejudicial to the promotion of a sound financial structure and/or contrary to the public interest (Section 46 of BAFIA) or if the outcome is detrimental to the soundness of the financial structure (Section 49 of BAFIA). Malaysia went through a transformation of its domestic banking structure after the Asian banking structure, consolidating banks into what is the eight current major banking groups.</p> <p>EC 4: BNM has knowledge of the names and holdings of all significant shareholders (including beneficial interests held through nominees) through the applications process described in EC 3 and through subsequent reporting on a semi-annual basis by banks via the Financial Institutions Corporate Profile System. Shareholdings are further reviewed as part of BNM's ongoing supervisory process.</p> <p>EC 5: Section 54 of BAFIA provides BNM with the power to prohibit the transfer of shares, the exercise of any voting rights, or the issuance of any further shares in the event of a change in control having taken place without supervisory approval. The new banking law would go further and provide for BNM to direct persons not approved to make acquisitions to cease exercising or to relinquish control over banks, including by divesting shares; failure to comply with such directives would trigger penalties.</p> <p>AC 1: BNM now gets information about material changes in the suitability of major shareholders through the general supervisory process rather than from any ongoing reporting requirement; it can then prevent the acquisition of further shares by a no-longer suitable shareholder but otherwise has little capacity to address the situation. The new law would codify the obligation on directors of officers of banks to provide material negative information on major shareholders to BNM and subject major shareholders to an ongoing suitability requirement.</p>
Assessment	Largely Compliant
Comments	The framework for controlling the ownership of banks is a good one, but should be

	<p>refined as follows:</p> <ul style="list-style-type: none"> • BNM must have the capacity to address directly unauthorized acquisitions of shares, or control, of a banking institution, such as requiring divestitures and/or cessation of control. • BNM should have an ability to learn about and deal with changes in the suitability of major shareholders. <p>The draft FSA, if enacted, should address these issues.</p>
Principle 5	<p>Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations and confirmation that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
Description	<p>EC 1: Section 30 of BAFIA requires a bank to obtain the prior written consent of BNM to open any office inside or outside Malaysia. Section 29 of BAFIA requires a bank to obtain prior approval from BNM to establish or acquire any subsidiary in or outside Malaysia. As discussed in CP 24, BNM has, through the imposition of conditions in bank acquisition approvals, subjected FHCs to the same prior approval requirements.</p> <p>In the case of investments in shares, limits on a bank's investments are set out in the Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes as follows:</p> <ul style="list-style-type: none"> • The aggregate book value of the bank's investments in shares and interest-in-shares shall not exceed 25 percent of the bank's capital base; and • The aggregate book value of collective investment schemes, immovable properties and investments in shares and interest-in-shares shall not exceed 50 percent of the bank's capital base. <p>As discussed with the BNM supervisors, and as confirmed by the assessors' review of a relevant court case, guidelines such as the above, are considered to have the force of law. BNM is in the process of cleaning up its array of regulatory or guidance mechanisms to make that distinction clearer and provide greater transparency through placing relevant documents on its web-site.</p> <p>EC 2: Existing laws and regulations do not explicitly specify the criteria by which individual proposals are considered. Prior to formal submission of a proposal, a bank typically expresses its intention to BNM and preliminary discussions are then initiated between BNM and the bank regarding the criteria to be used.</p> <p>According to BNM internal documents provided to the assessors, the criteria considered by BNM in assessing proposals for investments in subsidiaries or associated companies, include the following:</p> <ul style="list-style-type: none"> • Financial capacity and soundness of the financial institution i.e., having the capital, expertise and track record to support the acquisition or investment; • Strength of shareholders and ability to provide sustainable support to the

	<p>bank;</p> <ul style="list-style-type: none"> • Strength of senior management and Board of Directors; • Source(s) of funding for the acquisition or investment; • Effects (if any) of the acquisition or investment on the bank's existing operations; • Reasonableness of the business plan; • The bank's familiarity with and consideration of the operating and regulatory environment overseas, where relevant; and • If investments are made abroad, BNM's ability to conduct on-site examinations and access to data and information as well as any restrictions that may impede effective supervision by BNM. <p>Assessor discussions with banking organizations indicate general awareness of these expectations, with the view expressed by the bankers that funding for the investment and its effect on capital/goodwill are especially critical to the BNM analysis.</p> <p>EC 3: BNM takes into consideration the operating and regulatory environment in the host country in which a bank proposes to undertake an acquisition or investment. As part of the assessment procedure, BNM would engage with the overseas regulator to ascertain whether there are any legal or policy requirements which prohibit BNM from conducting on-site examinations on the proposed entity overseas or restrict BNM from having access to the information and data of the entity for purposes of effective consolidated supervision.</p> <p>BNM advises that it would not grant approval to a bank to make the acquisition or investment in the event that access to information is restricted, which would impede effective consolidated supervision by BNM. To-date, where banks have foreign establishments, BNM has been able to conduct on-site examinations of the banks' overseas operations, in cooperation with the respective host supervisors without encountering any difficulty.</p> <p>EC 4: Once an application is submitted by a bank, BNM will make an assessment of the bank's financial resources and qualitative factors, including the governance structures to manage the investments and the track record in managing acquisitions or investments, particularly those abroad. Assessor discussions with bankers confirmed that intended acquisitions are being evaluated by BNM in a rigorous way, focusing on funding, intended activities, and governance.</p> <p>The assessment of a bank's financial capacity is based on BNM's existing supervisory knowledge of the bank, including supervisory assessments, information submitted by the bank in its proposal and in response to questions on the impact of the acquisition or investment on the bank's resources, whether financial or organizational; an evaluation of the ability of the bank's shareholders to support such an acquisition or investment and the access to sources of funding to undertake the acquisition or investment as well as the bank's repayment capacity if such acquisition or investment is funded through borrowings; and consideration of the goodwill impact and cost of the acquisition to ensure that the bank's overall financial resources will not be impaired</p>
--	---

by the proposed acquisition or investment.

BNM also considers qualitative factors, such as risk management and governance, looking for satisfaction that the bank has the manpower to manage the acquisition. If there have been previous acquisitions, BNM also reviews the effectiveness of previous integration efforts.

EC 5: Prior blanket approval is granted by BNM or MOF for investments in “designated companies” and acquisition of properties pledged as collateral, as stated in BNM’s Guidelines on Shares, Interest-in-Shares and Collective Investment Schemes. The “designated companies” are Cagamas Bhd, Credit Guarantee Corporation Malaysia Bhd, SWIFT, ABM-MCD Holdings Sdn Bhd and Financial Park (L) Sdn Bhd. These companies have been designated in view of their role to develop and promote key sectors that are of strategic importance to Malaysia.

These investments are subject to the following overall investment limits imposed on banks:

- The bank’s total investment in trustee and non-trustee shares does not exceed 25 percent of its paid-up capital and published reserves; and
- The bank’s total investment in shares and immovable properties does not exceed 50 percent of its capital base.

Notice of investments or acquisitions below these limits is given to BNM through BNM’s supervisory oversight process with individual banks.

EC 6: As a matter of policy, banking groups are not allowed to engage in non-financial activities except if ancillary or incidental to financial services, such as the provision of non-core operational functions and back office functions, which include distribution, administrative and management services (e.g., property management for own use).

As noted above, acquisitions of financial companies are evaluated under criteria that include consideration of the goodwill or funding effects on the acquirer. Under the specific conditions it imposes on FHCs (see CP 24), similar reviews take place for acquisitions by an FHC of such companies – as with bank acquisitions, the criteria are not currently explicit. However, BNM does not have explicit statutory authority to issue directives of compliance to the FHC or its unregulated affiliates should the affiliate subsequently conduct its business in a manner detrimental to the bank.

AC 1: As elaborated in EC 2, among the assessment criteria applied by BNM in reviewing a bank’s proposal to make acquisitions or investments abroad are the regulatory environment in the host country, including the ability of BNM to exercise effective consolidated supervision over the overseas branch or subsidiary.

BNM also assesses whether there are any restrictions that would impede effective consolidated supervision, such as any restriction prohibiting BNM from accessing data and information and any prohibiting BNM from conducting on-site examinations.

Assessment	Largely compliant
Comments	<p>Overall approach is effective but there are some improvement opportunities:</p> <ul style="list-style-type: none"> • BNM needs to codify criteria to be applied to major acquisitions by a bank or FHC. more explicitly; • BNM needs more explicit authority to take corrective action against non-banking companies that could be acquired if they subsequently prove to be detrimental to the interests of the bank affiliate.
Principle 6	<p>Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.</p>
Description	<p>EC1 BNM has the legal power under section 37(1) of BAFIA to specify a minimum capital ratio to be maintained by all banking institutions licensed under these legislations. Pursuant to the provision above, BNM has established and issued a capital adequacy framework which stipulates the minimum capital requirement, capital adequacy ratio computation, definition of components of capital, computation of risk weighted assets, internal capital adequacy assessment process and disclosure requirements in these guidelines:</p> <ul style="list-style-type: none"> • Risk-Weighted Capital Adequacy Framework (General Requirements and Capital Components); • Risk-Weighted Capital Adequacy Framework (Basel II - Risk-Weighted Assets Computations); • Risk-Weighted Capital Adequacy Framework (Basel II—Pillar 2); • Risk-Weighted Capital Adequacy Framework (Basel II—Pillar 3); <p>The components of capital are described in RWCAF and are consistent with the BCBS's requirements to ensure that prominence is given to loss absorbing capital components.</p> <p>EC2 BNM does not distinguish the application of its capital adequacy requirements between internationally active and non-internationally active banks. Paragraph 5.1 of RWCAF (GRCC) requires banking institutions to maintain a minimum risk-weighted capital ratio of 8 percent at all times at the entity and consolidated level. Generally speaking, the capital adequacy requirements are in line with the BCBS recommendations. There are, however, a few areas where the regulation has not yet been aligned with international standards. These are:</p> <ul style="list-style-type: none"> • Scope of application of the framework is not extended to the holding company of a banking group (See paragraph 21 of BCBS's Basel II standard) as BNM currently does not have explicit legal powers to do so. • Definition of capital:

	<ol style="list-style-type: none"> 1. Deductions are currently made at the total capital level (except for goodwill, which is deducted from Tier-I capital) instead of 50% from Tier-I capital and 50 percent from Tier-II capital. (See Part C in Annex 1a of BCBS' Basel II Standard); and 2. For banking institutions that use the Standardized Approach for credit risk, inclusion of general provision in Tier-II capital is currently not subjected to the limit prescribed by the BCBS as stipulated in paragraph 49 (x) (a) of BCBS' Basel II standard; <p>EC 3 BNM has the power to impose specific capital requirements under section 37 (1) of BAFIA . Currently, the BNM imposes capital charges for credit risk, market risk and operational risk.</p> <p>EC 4 Under RWCAF (B2-RWA), BNM requires banking institutions to capture all on and off-balance sheet exposures in the computation of capital adequacy requirements. As at June 30 2011, banks adopt the following approaches to capital requirements in Malaysia.</p> <p>Credit Standardized Approach: 48 banks Internal Ratings Based Approach (IRB) (foundation): 10 banks Market Standardized Approach: 58 banks Operational Basic Indicator Approach (BIA): 56 banks Standardized Approach (TSA): 2 banks</p> <p>The capital floor for banking institutions using the IRB approach is still applicable consistent with the Basel Committee on Banking Supervision's standards. However, BNM may continue to impose the prudential floor beyond the transitional period to ensure individual banking institution's implementation of the IRB approaches are sound.</p> <p>EC 5 The RWCAF (B2-RWA) were developed with some refinements made to address any potential underestimation of risk for exposures in Malaysia as well as to ensure the framework can be suitably applied in the local environment. Examples of areas of refinements are as follows:</p> <ul style="list-style-type: none"> • Adoption of more conservative treatment based on benchmarking of other regulatory practices—20 percent credit conversion factor (CCF) applied on unutilized credit card lines instead of 0 percent CCF (paragraph 2.84 of RWCAF (B2-RWA)); • Higher interest rate risk capital charge for market risk for exposures to non-G10 countries (paragraphs 5.51 to 5.52 of RWCAF (B2-RWA)—to reflect more volatile financial market conditions observed in emerging economies; • No recognition of the available-for-sale revaluation reserves in Tier-II capital although BCBS' Basel II standard (paragraph 49 (vi)) allows for recognition of 45 percent of these reserves in Tier-II capital; and • Differentiated risk weights to better reflect the underlying risk of specific exposures: <ol style="list-style-type: none"> 1. Risk weights applied on performing residential mortgages range from 35 percent to 100 percent based on the loan-to-value (LTV) ratio of each exposure, instead of a standard 35 percent risk weight (paragraphs 2.32 to 2.33 of RWCAF (B2-
--	--

	<p>RWA); and</p> <p>2. Term loans for personal use with an original maturity of more than 5 years are 100 percent risk weighted, instead of 75 percent risk weight (paragraph 2.29i of RWCAF)</p> <p>EC 6 The relevant legal provisions for BNM supervisors to take measures should a banking institution fall below the minimum capital ratio are stipulated as follows:</p> <ul style="list-style-type: none"> • Section 37 (Fourth Schedule), section 73(1)(b)(iii) and section 103(1)(b) of BAFIA; and • Section 37. <p>Notwithstanding the above, BNM adopts a pre-emptive approach where banking institutions would not be allowed to maintain a capital adequacy ratio below a certain threshold set for individual banking institutions (that is above the regulatory minimum of 8%), determined through the supervisory assessment process. For banking institutions with higher risk profiles and which are more susceptible to changes in business environment, BNM supervisors impose a higher minimum capital ratio requirement. Under the Supervisory Intervention Guide (SIG), banking institutions with “High” Composite Risk Rating (CRR) are typically also subjected to more intense intervention actions which may include a requirement for capital injection. These institutions are also subjected to more granular reporting requirements to ensure continuous flow of critical information to facilitate supervisory monitoring. See also CP 23 for a more detailed discussion on supervisory powers.</p> <p>EC 7 The BNM has accredited 10 banks for the use of the foundation IRB approach. The assessment criteria are stipulated in and qualifying criteria (minimum requirements) have been stipulated in RWCAF (B2- RWA). Banking institutions are also guided by the Implementation Guidance (IG) to the Internal Ratings-Based (IRB) Approach for Credit Risk issued together with the RWCAF (B2-RWA). The IG provides additional guidance. The assessors were given an overview of the accreditation process and concluded that the BNM adopts a rigorous and detailed review initial and ongoing review before the advanced Basel approaches can be adopted.</p> <p>AC1 The BNM does not distinguish between internationally active banks and non internationally active banks for capital adequacy purposes., hence the treatment is the same as mentioned in EC2</p> <p>AC 2 There is not distinct capital treatment for internationally active banks and non-internationally active banks. Non bank holding companies are currently not subject to any capital adequacy requirements.</p> <p>AC3 BNM does not have a specific requirement for banking institutions to adopt a forward-looking approach to capital management and setting of capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect. However BNM sets out its supervisory expectations in the following guidelines:</p> <ul style="list-style-type: none"> • Paragraph 9.4 of RWCAF (B2-P2);
--	---

	<ul style="list-style-type: none"> • Guidelines on Stress Testing; and • Paragraphs 3.354 and 5.168 of RWCAF (B2-RWA), which provides specific requirements for banking institutions adopting the IRB approach for credit risk and Internal Model Approach for market risk. <p>Although the BNM has had discussions with banks on Pillar II implementation and banks prepared a gap analysis, it has not yet fully implemented Pillar II. Some elements of Pillar II are operating, as banks are required, on an annual basis to submit and present their business strategies, including the adequacy of capital to support the strategy. Banks are also required to integrate the outcome of stress tests into their risk appetite and capital management plan. Formal ICAAPs have yet to be submitted and reviewed by the BNM.</p> <p>AC 4 Currently capital adequacy requirements are not imposed on financial holding companies heading a banking group. That said, entities that are part of a banking group but not regulated by the BNM (asset managers, venture capital entities...) are subject to regulatory oversight and site inspections by BNM under the authority derived from BAFIA (see CP 24).</p> <p>AC5 In accordance with paragraph 1.5 of the RWCAF, the BNM has the power to require a regulated entity to maintain higher regulatory capital requirements and has exercised this power. This power is exercised as part of the supervisory assessment process under SuRF. Under the supervisory process, BNM adopts a pre-emptive approach to prevent a banking institution's capital from falling below the level that BNM deems adequate to support the institution's risk profile.</p>
<p>Assessment</p>	<p>Largely compliant</p>
<p>Comments</p>	<p>Banks remain well capitalized with system-wide risk-weighted capital ratio and core capital ratios at 14.9 percent and 12.9 percent respectively in 2011. In general, the capital adequacy ratios namely RWCR and CCR declined between 0.4 to 4.8 percentage points and 0.1 to 3.7 percentage points respectively upon transition to the IRB Approach. This was largely due to shortfall in loan loss provision against credit expected loss based on IRB estimates as well as the introduction of capital requirement for operational risk.</p> <p>The scope of application of the capital framework should be widened to include financial holding companies, as outlined in the Basel II scope of application.</p> <p>Some other, but minor, amendments, to fully align the capital framework with the BCBS standards should also be made. The assessors, however believe the impact not to be material, particularly in view of the other areas where the BNM is stricter than the Basel minimum.</p> <p>Basel II consists of three mutually reinforcing pillars; the BNM should therefore also fully implement Pillar 2 as soon as possible Having a Pillar 1 and Pillar 3 in place, without a full fledged Pillar 2 is, strictly speaking, not in line with sound Basel II implementation.</p> <p>Moving forward, BNM will have enhanced legal powers under the new financial services legislation to enable the application of capital framework on financial holding companies and is in the process of fully aligning the definition of capital with the implementation of Basel III in Malaysia.</p> <p>The BNM intends to move to the full implementation of Basel III in accordance with the</p>

	internationally agreed timetable.
Principle 7	Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including board and senior management oversight) to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	<p>EC 1: BNM's requirements on banks and banking groups to have comprehensive risk management policies and processes are embedded in the following:</p> <ul style="list-style-type: none"> • Guidelines on Corporate Governance for Licensed Institutions; • Best Practices for the Management of Credit Risk—Chapter 2 Section 4 and specific requirements on lending policy in the box and Chapter 3; and • Risk-Weighted Capital Adequacy Framework (Basel II—Risk-Weighted Assets Computation):for banks adopting the internal ratings-based approach for credit risk (Section B.3.7 from Paragraph 3.376 to 3.410); and standardized approach and internal model approach for market risk—Page 220 Paragraph 5.16, 5.17 and page 308 section D.3.7. <p>The power of BNM supervisors to require a bank to address inadequacies in risk management processes is derived from:</p> <ul style="list-style-type: none"> • BAFIA—Sections 69 and 71, and Section 79 for related entities <p>Currently, there is no similar power for BNM supervisors over non-licensed entities in a banking group, including the FHC parents of groups. However, as discussed in detail in CP 24, BNM has been reaching out more to the FHCs (in the past year in particular), effectively extending its reach to a significant extent in practice to include FHCs and their non-regulated affiliates. The consistency and strength of the application of risk management expectations to the consolidated FHC can be improved.</p> <p>BNM supervisors do on-site reviews to determine that banks' risk management processes are adequate and commensurate with the size and nature of activities, as they:</p> <ul style="list-style-type: none"> • Review minutes of the Board and Board Risk Committee's (BRC) discussions on business plans, risk management strategies, policies and processes, focusing on the Board's identification and understanding of significant risks based on the current risk profile, possible changes in risk profile as a result of business plan implementation and external developments; and possible constraints in risk management processes including information technology and human resources that require enhancements or adjustments in order to manage the new risk profile. The assessors reviewed a number of the BNM supervisory notes on such minutes to confirm that they provided the degree of detail needed to make such assessments. The assessors also discussed directly with banks the guidance given by BNM on preparation of such minutes, and were told of the

	<p>strength of the guidance given on the granularity required.</p> <ul style="list-style-type: none"> • Review stress test reports submitted to the Board and BRC, focusing on the process of establishing stress scenarios to see if they are adjusted when circumstances change; nature of the Board discussion of the relevance of shocks to be applied; the direction of risk-taking activities in the next year, the external environment; and actions to be taken to mitigate the potential impact from stress (e.g., changes in risk management). • Review risk reports submitted to the Board, BRC and other committees (e.g., ALCO, Credit Committee) and to the CEO. <p>EC 2: For large banking groups, on an annual basis, BNM supervisors will convene a session for senior management of banking institutions on broad strategies, business plans and risk management strategies. The assessors confirmed with banks that such sessions are being held.</p> <p>To ensure that the Board has approved the bank's risk management strategies and policies, BNM supervisors perform the following:</p> <ul style="list-style-type: none"> • Review the Board's terms of reference and risk management framework to confirm the explicit role of the Board in reviewing and approving risk strategies and policies and to determine the line of demarcation between the Board and Board Committees; • Review the Board's meeting minutes, focusing on the Board's review, deliberations and approval of the bank's risk appetite, risk management strategies and risk management policies. <p>To ascertain that the policies and processes for risk-taking are developed and appropriate limits are established, consistent with the approved risk management strategies, BNM supervisors review the following:</p> <ul style="list-style-type: none"> • Policies and limits on risk-taking (e.g., credit granting criteria and limits, trading policy and limits) and risk control (trading position stop-loss limit). • Procedures manuals; • Minutes of the Board and BRC; • Internal audit reports on risk management and significant risk taking units. <p>To ascertain that the Board ensures that senior management takes the requisite steps to monitor and control all material risks consistent with the approved risk management strategies, BNM supervisors review risk reports submitted to the Board to ensure that the Board is informed of the bank's exposures to all material risks and review internal audit reports to identify non-adherence to the established internal risk control constraints (e.g., internal limits) and whether the Board Audit Committee (BAC) and the Board are informed of the non-adherence.</p> <p>EC 3: Prior to on-site review, BNM supervisors review documents on banks' risk management strategies, policies, processes and limits, including policies and limits on exceptions to assure comprehensive coverage, to assess the extent of the updating to reflect changes to business plan, risk appetite, operating environment and regulations, to</p>
--	--

assess the adequacy of strategies to support implementation of business plan and to assess the effectiveness of the role played by the independent risk management function in challenging the adequacy of risk policies and limits.

In order to ascertain that risk management strategies, policies, processes and limits are communicated and adhered to, BNM supervisors on-site engage in transactions testing based on sampling to check adherence to internal risk-taking criteria and limits, processes and procedures; the sample is based on top large exposure amounts, recent transactions, and transactions made during periods of aggressive business growth. Discussions are held with officers and staff to ensure effective communication is taking place.

On-site examination on branches and overseas operations are conducted based on their contribution to the organization's overall asset size and revenue, risk profile and severity of internal audit findings. Some are on a regular cycle, others are subject to this specific determination.

To ascertain that exceptions to policies, processes and limits are promptly attended to and properly authorized, BNM supervisors review policies and procedural manuals on handling, authorization and reporting of exceptions to assess clarity of types of allowable exceptions, limits and trigger threshold for management actions, approving authority for exceptions, monitoring and reporting requirements of exceptions; exceptions reports submitted to the Board, relevant committees and senior management to address timeliness of reporting and authorization of exceptions, appropriateness of policy vis-à-vis exceptions in practice, understanding the exception reasons and impact on risk appetite and formulation of remedial actions; and internal audit reports on non-adherence to internal risk policies, processes and limits.

EC 4: To ensure that the Board understands the nature and level of risk being undertaken by the bank, BNM supervisors review risk and capital adequacy assessment reports that are submitted to the Board, Board committees, and management committees to make sure that all significant risk events, their profile and capital consumption, are reported and appropriately deliberated; stress test reports that are submitted to the Board, BRC and management committees to determine the degree of deliberation on changes required in business and risk management strategies as well as risk mitigation and capital planning; new structured product approval submissions to BNM (if any) to determine the depth of review by senior management on new risks arising from new products and activities and senior management's alignment with risk appetite approved by the Board; the Board's annual attestation to BNM to ensure that the requirement, under BNM's Guideline on Introduction of New Products that the Board reviews criteria and processes, has been addressed.

BNM supervisors engage with individual directors and key senior management (e.g., CEO, heads of risk-taking units and Chief Risk Officer (CRO)) to gauge the level of understanding of individual directors and senior management with regard to the bank's risk profile, capital consumption for risk undertaken and capital requirement for future risk-taking activities, as well as how the risk being taken by respective units contribute to the bank's overall risk profile and affect overall internal capital target; their awareness on specific issues affecting the bank, the depth of discussions and

the extent of challenge posed by the Board. Directors are probed on specific issues uncovered during the review of various risk reports prior to the engagement; and on their understanding of the rationale for risk-taking decisions made and potential consequences. Discussions by the assessors with banks (and one of their directors) confirmed the direct reach to individual directors by the BNM for such discussions.

To ascertain that senior management ensures that risk management policies and processes are appropriate to the institution's risk profile and business plan and implemented effectively, BNM supervisors assess the role of the independent risk management function to identify the extent of critical challenges and feedback provided to senior management's proposals on risk policies, processes and business plans.

BNM's requirements on appropriateness of risk management policies are included in the following guidelines and manuals:

- Guidelines on Corporate Governance for Licensed Institutions – Principle 1;
- Risk-Based Supervisory Framework;
- Manual for Examination of Banking Institutions – Risk Management;

BNM's requirements on senior management and the Board's understanding of the nature and level of risk being taken and how this risk relates to adequate capital levels are embedded in the following guidelines and manuals:

- Guidelines on Corporate Governance for Licensed Institutions – Principle 1;
- Guidelines on Fit and Proper for Key Responsible Persons – Paragraph 5.6, Section 6;
- RWCAF—Internal Capital Adequacy Assessment Process (Pillar 2) —Part B Paragraph 6.1, 7.1 and 7.3; and
- Guideline on Stress Testing—Part A Paragraph 1.04

EC 5: BNM's Supervisory Risk-Based Framework (SuRF) requires BNM supervisors to review the capital management policies and practices of banks. The review is necessary to determine the adequacy of capital in terms of the quality of its capital, the size of the available buffer to support losses under plausible stress scenarios, and its sufficiency to support planned expansion and growth. The assessment is also necessary for deriving the Composite Risk Rating (CRR) of each bank.

To ascertain the adequacy of the capital assessment of banks, BNM supervisors review banks' capital management framework to ensure that:

- There are adequate policies on capital planning and clear responsibilities and accountabilities for the internal capital assessment process;
- Capital planning is integrated with the bank's strategic and business plans;
- There are proper criteria used to set internal capital targets that recognize the risk profile and risk appetite of the bank, as well as the quality of capital;
- Capital planning is subjected to stress tests; and
- There is an established process for periodic review of capital adequacy, as a result of business plan implementation and changes in risk profile.

For large banking groups, more experienced BNM supervisors perform the review with more use of risk specialists to assess complex risk models and economic capital models that are used by the banks in their capital assessment. In discussions with banks, the assessors confirmed that model validation on the part of the BNM risk specialists was taking place. However, model validation is an exception to a general approach, which has the relatively small number of risk specialists in various disciplines spend only limited time on-site and more time advising the line supervisors on issues; the supervisory teams do have some individuals with experience in various of the risk dimensions.

For small or less-complex banks, BNM supervisors allow them to use a more qualitative approach in capital planning. At a minimum, these banks are required to conduct a stress test analysis to identify sources of vulnerability, potential impact on earnings and capital and required capital buffer.

Moving forward, BNM supervisors' review of banks' internal capital adequacy assessment process will be more structured under the Basel II Pillar 2 and ICCAP processes when they are implemented. On ICAAP, BNM has recently issued requirements for banks to have an internal process for assessing capital adequacy in relation to risk profile are embedded in RWCAF – Internal Capital Adequacy Assessment Process (Pillar 2) under Part A Paragraph 1.3, Part B Paragraph 6.1 and 6.2, whereas Part C Paragraph 12.1 of the guideline specifies the provision on supervisory review of banks' ICAAP and BNM's rights to require banks to improve capital and risk management processes. Under this guideline, BNM requires banks to comply with this guideline proportionately to their size, complexity and nature of activities.

EC 6: To ascertain that banks conduct periodic and independent validation and testing of models and systems, BNM supervisors review the overall risk model governance to ensure that there are policies and procedures for independent back-testing and validation on a periodic basis. BNM supervisors expect risk models and systems to be validated at least on a yearly basis, and done so with clear responsibilities and accountabilities for the validation function with adequate segregation of duties. If the validation function is outsourced to an external party, there are policies and procedures to govern the outsourcing, specifically on the scope of coverage of validation and reporting of validation outcome.

BNM also reviews validation and back-testing reports and performs a walkthrough of the validation process with the validation team to ascertain that validation is in fact conducted with the appropriate independence, and that problems are highlighted to senior management and remedial actions are proposed and taken. BNM supervisors are assisted by BNM's risk specialists to review technical aspects of risk model validation.

For banks that adopt the IRB, BNM supervisors review the credit risk model validations conducted by the banks as part of the overall assessment before the banks are allowed to use IRBA for regulatory capital computation and reporting under Basel II Pillar 1 following the validation protocol described above.

EC 7: BNM's SuRF requires the BNM supervisors to assess the quality (i.e. accuracy, integrity and depth), timeliness and insightfulness of the Management Information

System (MIS) that supports the risk management process. BNM supervisors review the policy of MIS and risk reporting to ascertain that it captures risk exposures comprehensively and with sufficient granularity in line with the bank's risk profile, nature and complexity of risk-taking activities at an individual entity and group-level. They review policy and perform a walkthrough on risk models to ensure that models are able to measure risks in a timely manner, and data input and output have integrity: They also review the risk reports submitted to the Board and Risk Management.

EC 8: Under the new Guidelines on Introduction of New Products issued in 2011, the Board is required to provide an annual attestation to BNM that the conditions and requirements of the guideline have been met throughout the reporting period. The guideline requires the Board to endorse appropriate policies and procedures to prudently manage risks associated with the products offered by the banks, covering the product management program, product authorization and the ongoing monitoring and control of product risk. In any event, under the new guideline BNM retains the right to disallow any new product to be introduced in the market; the assessors were shown examples of products that BNM has stopped banks from implementing.

To ensure that major risk management initiatives are approved by the Board, the BNM supervisors review minutes of Board and BRC meetings.

EC 9: BNM's SuRF requires the BNM supervisors to assess the adequacy of segregation of incompatible duties between risk taking and risk management functions. To ascertain that there is sufficient control to minimize conflict of interest, BNM supervisors perform an on-site review of the overall organizational structure of the bank to ensure that there is clear delineation of responsibility and accountability of units with appropriately independent reporting lines and sufficient stature and authority given to risk management. The process for evaluating and compensating risk professionals is reviewed to ensure decisions are not unduly influenced by risk-taking units.

The work process of risk management is reviewed to ensure that there is sufficient access to information and data for risk management units and officers to perform their function and that there is no dependency on a risk taking function to access information and data for the purpose of risk assessment and monitoring—e.g., the risk management unit that performs analysis on credit risk level based on internal rating of borrowers must have direct access to the internal database in order to obtain the ratings.

BNM supervisors meet with the CRO and key risk management officers to determine if there are constraints and limitations that the independent risk management function may be facing in performing their independent risk evaluation, monitoring and reporting duties. The assessors confirmed with senior risk professionals at banks that they meet regularly with BNY supervisors to discuss how they are able to carry out their responsibilities.

EC 10: The following standards have been issued by BNM:

Credit Risk

- Best Practices for the Management of Credit Risk; and
- Other credit risk management-related guidelines:
 - Classification and Impairment Provisions for Loans/Financing;

- Guidelines on the Credit Limit to a Single Customer (BNM/GP5);
- Credit Card Guidelines;
- Risk-Weighted Capital Adequacy Framework (Basel II – Risk-Weighted Assets Computation); and
- Guidelines on Credit Transactions and Exposures with Connected Parties.

Market Risk

- Risk-Weighted Capital Adequacy Framework (Basel II – Risk-Weighted Assets Computation) – section D.1.1 Page 219 on prudent valuation, section D.1.2 Page 222 on classification of financial instruments, section D.1.3 Page 226.

Liquidity Risk

- Liquidity Framework.

Interest Rate Risk in Banking Book

- Quarterly Submission on Interest Rate Risk Exposures.

Operational Risk

- Standards on operational risk-related are:
 - Guidelines on Outsourcing of Banking Operations;
 - Guidelines on Business Continuity Management;
 - Guidelines on Management of IT Environment (GPIS 1); and
 - Guidelines on Introduction of New Products.

Other Risk Management-related Guidelines

- Guidelines on Stress Testing;
- Prudential Standards on Securitization Transactions; and
- Minimum Standards on Risk Management Practices for Derivatives.

AC 1: Currently, BNM does not have a guideline that specifically requires banks to have a dedicated unit responsible for the risk management process. However, we have been advised that all of the domestic banks in Malaysia have a dedicated unit that undertakes the independent risk management function. For larger banks, the unit is staffed with more manpower and is divided into further specific sub-functions. Examples of the sub-functions include risk model development, risk model validation, portfolio analysis and risk policy.

AC 2: BNM's requirements on banks to conduct rigorous, forward-looking stress testing are embedded in the following guidelines:

- Guidelines on Stress Testing – Particularly Part A Paragraph 1.04 and 1.08, Part C;
- RWCAF – Internal Capital Adequacy Assessment Process (Pillar 2) – Part B Paragraph 9.4;
- Risk-Weighted Capital Adequacy Framework

To ascertain that banks conduct stress testing at a minimum on a semi-annual basis,

	<p>banks are required to submit their stress test documents containing the stress test scenarios and parameters used and stress test results to BNM (required under BNM’s Guidelines on Stress Testing). Any weaknesses identified from banks’ stress testing process are discussed with the bank’s officers in charge of stress testing and officers from the risk management function and highlighted to the bank’s Board in the CRR letters together with recommended actions to be taken. These stress testing expectations have not been applied to consolidated FHCs.</p> <p>AC 3: Other material risks such as strategic, legal and regulatory risks are assessed by the BNM supervisors under SuRF and reflected in the CRR of each bank on an annual basis. As embedded in BNM’s RWCAF – Internal Capital Adequacy Assessment Process (Pillar 2) (Part B Paragraph 8.1(iii), 8.3 and 8.5), banks are required to identify and assess all material risks, including reputational risk.</p>
<p>Assessment</p>	<p>Largely Compliant</p>
<p>Comments</p>	<p>The BNM has a good framework for risk management, but there are some improvement opportunities:</p> <ul style="list-style-type: none"> • Increase the number and experience level of risk specialists and ensure they spend more time • Ensure that under the current law (as well as the prospective new legislation)that prudential risk management policies are explicitly and consistently applied to consolidated FHCs • Ensure in particular that relevant stress tests are applied to consolidated FHCs. • BNM needs to issue a guideline that specifically requires banks to have a dedicated unit responsible for the risk management process.
<p>Principle 8</p>	<p>Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.</p>
<p>Description</p>	<p>EC 1The requirements for a bank’s Board to approve and periodically review the credit risk management strategy and significant credit and investment policies and procedures are encapsulated in the following guidelines and best practices:</p> <ul style="list-style-type: none"> • BNM/GP1, Major responsibilities of the Board (paragraph 2.1, bullet 1, 4, 5, 6, 7 and 8); • BNM/GP1, Responsibilities of Independent Directors (paragraph 2.3); and • BPCR(Chapter 1: paragraphs 1.2, 1.3, 1.4 & specific requirements by BNM paragraph 1.1). <p>The guidelines require that the Board be held responsible in reviewing and approving on a periodic basis (at least annually), the bank’s credit risk strategies, business plans, significant credit and investment policies and processes. In addition, the Board is required to monitor senior management’s performance in implementing the above</p>

requirements and ensure that the bank establishes comprehensive credit risk management policies, processes and infrastructure, to manage the institution's credit risk. Meanwhile, the requirements for senior management to implement the credit risk strategy approved by the Board and to develop credit risk policies and processes are spelt out in the following guidelines and best practices:

- BNM/GP1, Principle 3 (paragraph 2.36); and
- BPCR (Chapter 1: paragraphs 2.1, 2.2 and 2.3)

The assessors reviewed the supervisory documentation for a number of regulated entities and were satisfied that the supervisory procedures adopted to confirm the requirements above were adequate.

EC 2 BNM's requirements for banks to have robust policies and procedures appropriate with the bank's credit risk environment and documented credit strategy are encapsulated in the following guidelines, best practices and concept papers:

- A well-documented strategy and sound policies and processes for assuming credit risk:
- BPCR (Chapter 1) Credit Culture 3.2 (ii), (vii) and (viii);
- BPCR (Chapter 2) Maintenance of adequate policies and procedures, 4.2 and specific requirements by BNM on Lending policy, 3.1 (ii) & (iii); and
- BPCR (Chapter 2) Lending policy 4.5.

Well-defined criteria, policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposure:

- BPCR (Chapter 2) Maintenance of Adequate Policies and Procedures, Specific Requirement by BNM on Lending Policy;
- BPCR (Chapter 3) Credit Granting Criteria, Evaluation of Credits, Approval of Credits, Specific Requirement by BNM on Credit Approval by the Board;
- Responsible Lending Financing Guidelines; and
- Credit card guidelines specifically for credit card business (paragraph 27.2).

Effective credit administration, policies and processes, including continued analysis of borrower's ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral and a classification system that is consistent with the nature, size and complexity of the bank's activities or at least, with the asset grading system prescribed by the BNM supervisor:

- Responsible Financing Guidelines;
- BPCR (Chapter 2) Specific Requirement by BNM on Collateral Policy;
- BPCR (Chapter 3) Risk Measurement and Specific Requirement by BNM on

	<p>Internal Credit Risk Rating System;</p> <ul style="list-style-type: none"> • BPCR (Chapter 3) Monitoring and Review of Credit Exposures; and • The Classification and Impairment Provisions for Loans/Financing Guideline, Section B, 7.0 on Credit Risk Grading. <p>Prudent lending controls and limits, including policies and processes for monitoring exposures in relation to the limits, approvals and exceptions to limits:</p> <ul style="list-style-type: none"> • BPCR (Chapter 2) Maintenance of Adequate Policies and Procedures, Specific Requirement by BNM on Lending Policy; and • BPCR (Chapter 3) Monitoring and Review of Credit Exposures. <p>The assessors reviewed the supervisory documentation for a number of regulated entities and were satisfied that the supervisory procedures performed to confirm bank's compliance with the requirements mentioned above were adequate.</p> <p>EC3 BNM GP1 2.06 states that a major responsibility of the Board among others is to establish procedures to avoid self-serving practices and conflicts of interest including dealings of any form with related entities. In meeting this requirement, the Board is required to establish policies and procedures governing related party transactions and conflict-of-interest situations.</p> <p>The following legal provisions and BNM Guidelines require the banks to make credit decisions free of conflicts of interest and on an arm's length basis:</p> <ul style="list-style-type: none"> • BAFIA, section 62, Prohibit lending to directors; • BAFIA, section 64, Disclosure of interest by director; • BPCR (Chapter 3) Specific requirement by BNM on Credit Appraisal Requirement (paragraph 2.3); and • GP6, Guidelines on section 26A of BAFIA, Prohibition of loans to directors <p>The assessors were shown supervisory documentation and evidence of onsite reviews where BNM supervisors assessed the adherence to the legal and regulatory requirements mentioned above.</p> <p>EC 4 BAFIA states that banks have to submit information to BNM as and when it is required:</p> <p>Section 21: Submissions of documents, etc.;</p> <p>Section 41 (1) and (3): banks are required to submit their financial statements to BNM;</p> <p>Section 65 (2) (a): BNM may by written notice direct a bank to submit any information relating to its policies and procedures for the giving of any credit facility; and</p> <p>Part X, Powers of supervision and control over licensed institutions section 69-71.</p> <p>BNM also requires banks to report their customers' credit exposures and monthly conduct via BNM's database on credit exposures ("the credit registry"). The aggregated as well as individual credit information from this database is used by BNM supervisors</p>
--	--

	<p>for off-site surveillance (e.g., monitor loan growth, asset quality trend analysis, etc).</p> <p>AC 1 The BNM does not have a specific legal requirement that requires banks’ senior management to decide on major credit risk exposures exceeding a certain amount or percentage of the bank’s capital. That said, in practice banks have in place an appropriate credit policy that limits major credit risk exposures from exceeding a certain percentage of their capital based.</p> <p>AC 2 The BNM accounts for potential future exposure by adopting the Current exposure method for the capital calculation of derivatives.</p> <p>AC 3 The total indebtedness of borrowers is recorded in the credit registry (individuals and corporate customers). Banks verify the credit registry during pre approval stage to assess an applicant’s total indebtedness and repayment capability by calculating among others, the debt servicing ratio. In addition, banks also assess customer’s total indebtedness post approval for the purpose of, among others, to determine new credit limit via behavioral scoring. For corporate exposures, banks generally review the borrower’s accounts at a minimum once a year. During such reviews, banks assess the borrower’s leverage level and this will be taken into account in determining a borrower’s credit rating. Banks require the corporate borrowers to submit their audited yearend financial accounts for review. In addition, the criteria, policies and processes to monitor the total indebtedness of borrowers are guided by the following BNM guidelines/concept paper (CP):</p> <ul style="list-style-type: none"> • Responsible Financing guidelines (paragraphs 6.6, 6.7 and 6.8); and • Classification and Impairment Provisions for Loans/Financing guidelines (paragraph 7.3)
<p>Assessment</p>	<p>Compliant</p>
<p>Comments</p>	<p>BNM is compliant with CP8. The regulations as well as the supervisory framework cover the overall credit risk process in terms of identification, management and mitigation.</p>
<p>Principle 9</p>	<p>Problem assets, provisions, and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.</p>
<p>Description</p>	<p>EC 1 The BNM/GP3 “Classification and Impairment Provisions for Loans/Financing” paragraph 9.3 as well as “Best practices for the management of credit risk” Chapter 2 paragraph 4.3 and Chapter 5 section 5 require banks to formulate policies and processes for identifying and managing problem assets. The requirement to conduct periodic reviews of the problem assets (individual or portfolio level for assets with homogenous characteristics) are also reflected in Paragraph 9.3 of BNM/GP3 “Classification and Impairment Provisions for Loans/Financing”. The assessors reviewed supervisory documentation and records to ensure the completeness and adequacy of the supervisory procedures performed.</p> <p>EC 2 BNM reviews and assesses the adequacy and appropriateness of the banking institution’s classification and provisioning policies, processes and implementation as part of the on-going risk based supervisory review. Such periodic reviews are conducted for corporate and commercial financing, consumer financing and treasury (investments in securities, equities and derivatives) portfolios. Review on the implementation of the</p>

classification and provisioning policy is done through discussions with the banking institution's relationship managers, independent credit review function, risk management and finance officers as well as review of the documentary evidence during the review of quarterly financial accounts. During this process, BNM ascertains whether the banking institution has effectively complied with the internal policies and conduct review of the problem assets, in terms of classification, provisioning, write-offs and write-backs (particularly for watch list, restructured and rescheduled accounts). Weaknesses identified in the policies and processes are communicated to the banking institution for rectification measures to be taken. BNM also conducts a series of follow-ups with the Board and senior management to assess whether the issues highlighted have been properly and timely addressed. The assessors reviewed supervisory files and other documentation and obtained comfort that the supervisory procedures are performed adequately and comprehensively.

Following the implementation of FRS139 Financial Instruments: Recognition and Measurement on 1 January 2010, all banking institutions are required to comply with the provisioning requirements therein and institute comprehensive policies and processes that are prudent and consistent with supervisory expectations. In confirming the adequacy of the provisioning policy and its implementation, BNM reviews the following areas as part of the on-going assessment on the banking institution's policies and practices:

- Review the threshold level set in distinguishing exposures to be assessed under Individual Impairment Provisioning (IIP) and Collective Impairment Provisioning (CIP). In principle, banking institutions are required to determine the criteria for exposures to be assessed under IIP. For credit exposures of a homogenous nature, banking institutions may segmentize credit exposures into groups of similar credit risk characteristics (such as loan/financing type, product type, market segment, credit risk grading and classification, collateral type, geographical location and past due status) for evaluation and analysis on a collective basis;
- In assessing the methodology in computing the provisioning amount, BNM ensures that banking institutions have a proper check and balance process for determining and measuring the amount of any impairment, including procedures on the appropriate measurement techniques to be applied.

Specifically, BNM assesses the following:

For IIP Methodology and Implementation

- BNM examines the adequacy of banking institution's provisioning policies and procedures and assesses the understanding of the credit and finance officers involved in the process. They must be able to demonstrate clear understanding of credit quality and be able to explain the procedures performed in computing the impairment loss amount. In addition, BNM reviews the scope and extent of work conducted by the internal audit and control functions to provide assurance that the implementation is strictly in accordance with the institution's policies, accounting standards and regulatory expectations;

- Based on sample reviews, BNM assessed the basis of the value of collaterals,

insurance claim assigned to the banking institution or the cash flows from the borrower's business operations (the Discounted Cash Flows (DCF) methodology is typically adopted to measure the impairment loss of each impaired exposure). BNM also obtains the documentation to evidence the claim of the banking institution on the future cash flows and determines whether the institution had exercised prudent judgment in deriving the value of the collaterals, including the discounting period used. As a guide, when the banking institution is unable to provide sufficient justification (through recovery data), that the collateral realizable period is shorter, BNM may require the banking institution to discount the cash flows, at a minimum, for a period of 5 years. Subsequently, BNM review the documentary evidence that support the reasonableness of assumptions used for cash flow from business operations by requiring the banking institutions to exercise sound and prudent credit judgment.

- BNM reviews the governance process in computing the IIP. The evidence provided by the business units in justifying the value of future cash flows must be sufficiently substantiated. Any assumptions used should be properly documented and subject to a proper validation process. BNM also reviews the role played by the management and Board committees in overseeing the provisioning process. This includes discussions with the Board on any gaps and concerns on the adequacy of the provisioning process.

For CIP Methodology and Implementation

- BNM reviews and obtains justifications from the banking institution on how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and factors considered to estimate credit experience. The common methodology adopted by banking institutions is by measuring Probability of Default (PD) and maximum Loss Given Default (LGD) for a particular credit portfolio;

- BNM assesses the reasonableness of techniques adopted by banking institutions in determining the PD. The common measurement techniques adopted by banking institutions in Malaysia are roll-over rate and migration analysis. BNM obtains this analysis and tests the justifications provided by the institution in computing the PD, which includes comparing the PD rate calculated for a particular loan/financing segment against the actual impairment rate. BNM also requires validation to be performed on the CIP model by an independent party;

- BNM reviews the process of segmenting credit portfolio according to homogeneous risk. The objective of this review is to determine the appropriateness of segmentation to adequately reflect the risk characteristics and historical credit losses into a reliable PD rate. BNM assesses whether the portfolio segments adopted for the purpose of calculating the CIP is acceptable and do not contain elements or assumptions that understate the PD rate.

- On LGD estimations, justification is obtained from the banking institution on the basis and assumptions used to determine the recovery rate. BNM also reviews the reasonableness of the valuation policy used for provisioning, such as the discounting period, degree of hair-cut and recoverable value.

EC 3 Banks in Malaysia comply with the accounting standards set by MASB which cover both onsite and offsite balance sheet and on balance sheet items.

EC 4 As referred to in EC 2, banks are required to establish prudent provision policies.

Paragraph 12.3 of BNM BNM/GP3 “Classification and Impairment Provisions for Loans/Financing” requires that the IIP and CIP are based on reasonable and well documented estimates of the net present value of future cash flows that are expected to be recovered. For credit exposures where the collateral pledged are specialized assets, BNM will require the valuation to be performed by a specialized valuer. During onsite examinations, BNM supervisors conduct end to end walkthroughs of the provisioning and write off processes to determine whether the bank complies with the regulatory requirements. Sample reviews are also performed on a regular basis verifying the implementation of IIP and establishing if any additional provision is required to reflect more realistic recovery expectations. The reasonableness of the loss rates are also reviewed.

EC 5 The BNM requires banks to establish appropriate governance processes, policies and procedures, measurement models and ensure appropriate resources for the early identification of deteriorating assets, ongoing oversight of problem assets and collection of past dues. The oversight and policy measures are included in the BNM/GP3 “Classification and Impairment Provisions for Loans/Financing” and in the document “Best practices for the management of credit risk”. The assessors reviewed examination records and other supervisory documentation and were satisfied with the adequacy and comprehensiveness of the supervisory procedures performed.

EC 6 BNM receives regular prudential returns from banks which allow it to assess the classification of credits and assets and provisions.

On Monthly/Quarterly Basis

- Statistical information on assets, liabilities and equities;
- Loans/financing - arrears in repayment, classification and provisions;
- Risk profile of treasury, corporate, commercial and consumer portfolio;
- Ageing listing and roll-over analysis by asset portfolio;
- Listing of exposures to large groups of borrowers (information obtained includes exposures to each borrower within the group and the repayment status of each borrower);
- Vintage analysis of the consumer and retail portfolio;
- Movement of large individual credit exposures into and from the impaired and vulnerable/ watch list categories;
- Report on impaired assets (information obtained includes details of impairment provisions, progress of recovery, collaterals and other sources of cash flows); and
- Report on progress of collection and recovery as well as update on watch list exposures (information includes repayment, signs of further deterioration, financial performance).

BNM may also obtain the following information from the banking institutions on a quarterly basis for the review of the quarterly financial accounts:

- Top 20 group customers and top 20 group impaired financing;
- Listing of material impaired assets;
- Movements in impaired financing;

- List of restructured and rescheduled financing during the period;
- Potential impaired financing and delinquent accounts;
- Movements of impairment provision made, write-back and write-off for each financing portfolio
- List of large individual impairment provision made, write-back and written-off with justification for the write-back and write-off;
- List of written-back accounts;
- Breakdown on available for sale (AFS), held to maturity (HTM) and held for trading (HFT);
- Inter-bank lending and borrowing for the last 3 months; and
- List of large newly classified and reclassified unimpaired accounts.

When BNM has particular concerns with regard to asset quality, it can of course obtain any additional information it requires (see CP 8, EC4)

EC7 The BNM has the power to require banks to make additional provisions if the impairment provisions for prudential purposes are deemed inadequate. Section 41 of BAFIA requires the BNM to approve the annual accounts of a banking institution and hence, the BNM can object to annual accounts that do not adequately reflect the impairment of the loan portfolio. Also, in accordance with paragraph 13.1 of the BNM/GP3 "Classification and Impairment Provisions for Loans/Financing" the BNM may require higher provisions and reserves or other remedial measures (see also CP 23). The power for BNM to require a banking institution to strengthen its overall financial capacity is embedded in the following legislation and guidelines issued by BNM:

- Section 37 BAFIA provisions on maintenance of capital funds unimpaired by losses as prescribed from time to time by BNM; and
- Risk Weighted Capital Adequacy Capital Framework - all banking institutions are required to maintain a minimum RWCR of 8% at all times at the entity, global and consolidated levels;

EC 8 BNM assesses whether banks comply with the minimum expectations with regard to the classification and provisioning for prudential purposes (see EC 2 and EC1). In this respect, BNM assesses, among other things, if

- Credit exposures are classified as impaired when the rules mentioned in EC 10 are met;
- Reclassification of restructured and rescheduled loans is only done after the observation period
- For loans with homogeneous characteristics, banks undertake a comprehensive assessment on the adequacy of CIP provisions.

In case the provisions are deemed to be too low, the BNM has the authority to require higher provisions as explained under EC 7.

EC 9 BNM requires banking institutions to develop and implement a system to periodically assess the value of risk mitigates to derive the net realizable value. The

collateral management system should incorporate the following:

- Valuation of collaterals to be conducted periodically or at a minimum once in two years;
- Collaterals for impaired assets required to be revalued on an annual basis;
- Valuation of collaterals to be conducted only by independent and qualified valuers;
- Collateral policy outlining parameters for appointment of panel valuers.

During onsite inspections, BNM supervisors review the collateral value in the system and the rationale and justification supporting the value. BNM appraises the capacity of the banking institution's collateral management system to maintain proper records and information on collaterals as well as generate timely and reliable reports to facilitate portfolio analysis.

EC 10 Financial assets are to be identified as impaired when there is objective evidence of impairment resulting from any loss event which has an impact on the estimated future cash flows. In addition, BNM/GP3 "Classification and Impairment Provisions for Loans/Financing" establishes classification rules based on repayment conduct. Loans/financing shall be classified as impaired when:

- The principal and/or interest is past due for more than 90 days. For revolving facilities, the exposure shall be classified as impaired where the outstanding amount has remained in excess of the approved limit for a period of more than 90 days;
- The exposure exhibits weaknesses that render adverse classification, although the past due is less than 90 days;
- For repayments that are scheduled on intervals of 3 months or longer, the loans/financing is classified as impaired as soon as a default occurs unless it does not exhibit any weakness that would render adverse classification;
- For restructured and rescheduled accounts where the amount is past due for 90 days or 3 months or less, these accounts shall be classified as impaired if they exhibit any weaknesses that render such classification as appropriate according to the banking institution's credit risk grading framework; and
- For restructured and rescheduled accounts already classified as impaired, banking institutions may only re-classify an exposure as unimpaired after prompt repayment conduct during the observation period (as prescribed by the banking institution's policy on restructured and rescheduled accounts).

EC 11 The guidelines on Corporate governance (see BNM/GP1, BNM/GP3 and BPCR) require banking institutions to establish broad parameters of information to be supplied to the Board and Risk Committees. Senior Management has the obligation to provide the Board with complete, focused and adequate information at least on a bi-monthly basis. During its onsite examinations, BNM reviews whether the Board receives relevant and quality information that adequately reflects and capture emerging risks. As a supervisory procedure, BNM also reviews the Board and Board committees minutes to assess whether the Board has active and in depth deliberations on the asset quality and

	<p>direction of asset growth.</p> <p>EC 12 See EC 1, 2, 4, 5 and 7 above. The BNM requires the assessment of small loans to be conducted on a collective basis and the assessment of larger loans to be conducted on an individual basis.</p> <p>AC1 In ensuring refinancing of loans/financing does not lead to improved classification, BNM/GP3 specifies that for restructured and rescheduled accounts already classified as impaired, banking institutions may only re-classify an exposure as unimpaired after prompt repayment conduct during the observation period (as prescribed by the banking institution's policy on restructured and rescheduled accounts). In this respect, BNM representatives indicated as a rule of thumb that a minimum of 6 months observation period is usual.</p>
Assessment	Compliant
Comments	BNM is in compliant with Principle 9. BNM has issued comprehensive guidelines specifying the requirements and regulatory expectations for banking institutions to have in place an effective system for management of problematic assets and processes to ensure the adequacy of provisions and reserves. In the event that BNM has supervisory concerns over banking institution's asset quality and adequacy of provisions, BNM has the power to require banks to increase the level of provisions and reserves as well as banking institutions financial strength via higher minimum capital requirements.
Principle 10	Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	<p>EC 1 Pursuant to section 61(4) of BAFIA, in computing the amount of any credit facility given to a single person, or any liability incurred on behalf of a single person, any single person is to include:</p> <ul style="list-style-type: none"> • An individual, his or her spouse, child or family corporation; • A corporation, its related or associate corporations; • Society registered under any written law relating to cooperative societies, its subsidiaries as defined in section 2 of the Cooperatives Societies Act 1948 and the related or associate corporations of such subsidiaries; or • Persons acting in concert with such single person provided that the Bank may specify that all or any of the persons or any particular person or any class, category or description of persons mentioned in the foregoing paragraphs shall be excluded in the application of this subsection in relation to any particular single person or any class, category or description of single persons, to which a credit facility is to be given and at the same time, specify the criteria or the basis on which the said person or persons are to be so excluded. <p>EC 2 The following legal provisions and regulatory standards deal with the requirements on counterparty exposures:</p> <ul style="list-style-type: none"> • Section 61(1) of BAFIA; • Part A Paragraph 5 and 7 of BNM/GP5; and • Revised Guideline for Investment in Private Debt Securities - Part B Paragraph

5, 6 and 7.

BNM/GP5 establishes the following limits to manage large exposures:

- Loan to any customer is set at 25 percent of capital funds;
- Overall limit for large loans is set at 50 percent of total credit facilities; and
- Large loan is defined as total credit facilities granted to any customer which exceeds 15 percent of capital funds.

In addition, the Revised Guideline for Investment in Private Debt Securities (1994) limits the holdings of corporate bonds issued by a single issuer to 10 percent of capital funds. However, banking institutions may increase holdings of corporate bonds issued by a single issuer up to 35 percent of capital funds provided that the amount of other credit facilities extended to the said single issuer within the 25 percent SCCL is reduced proportionately. In BNM/GP5, the scope of exposures includes loans and advances, bills and exchange discounted or purchased and off-balance sheet exposure in the form of guarantees and forward foreign exchange transactions. The above limits do not apply to government exposures.

The supervisory assessment of banking institutions' management of large exposures and concentration risk are embedded in BNM's supervisory framework and in the Guidelines on Best Practices for the Management of Credit Risk. The assessors have reviewed the supervisory documentation dealing with the assessment of credit concentrations and they were satisfied that BNM supervisors perform adequate assessments during their onsite visits.

EC 3 BNM's expectations for banking institutions to maintain sound management information system (MIS) to identify and aggregate large exposures are embedded in the following guidelines and manuals:

- Best Practices for the Management of Credit Risk - Chapter 2 Part 3;
- Paragraph 3.1 and 3.3 and Chapter 3 Part 2 Paragraph 2.10;
- Credit Risk Management Manual - Section: Introduction Part 2(c); and
- Manual for Examination of Banking Institutions - Topic D3: Concentration of Credits, Section D3.4.

As part of ongoing surveillance, BNM supervisors typically undertake supervisory procedures to assess banks' compliance with the requirements mentioned above. The assessors reviewed supervisory documentation to ensure these procedures were comprehensive and adequate.

EC 4 BNM's requirements that all material concentrations be reviewed and reported periodically to the Board are mentioned in the following guideline and manual:

- Best Practices for the Management of Credit Risk - Chapter 3 Part 2 Paragraph 2.16; and
- Credit Risk Management Manual - section: Introduction Part 2(a).

BNM supervisors monitor the concentration risk in the banking system on a quarterly basis based on the banking institutions' submission of top 20 credit exposures and

depositors. BNM supervisors assess and ascertain the level of concentration risk in the banking system by analyzing the submissions, the results of which are then escalated to BNM's senior management. BNM supervisors are also supported by BNM's Credit Risk Specialist Unit (CRSU) to provide a horizontal assessment on credit concentration and risk management practices across the banking industry. BNM supervisors update their assessment and on a monthly basis, report the risk profile of banking institutions to BNM's senior management via the Monthly Progress Report.

Banks also submit periodic reports with sectoral, geographical and currency concentrations. Concentrations in the property sector have been the most notable and the BNM has imposed specific limits on property exposures in the "Guideline on Lending to Broad Property Sector (BPS) and Lending for the Purchase of Shares and Units of Unit Trust Funds." Banking institutions are required to comply with the following lending limits:

- The average monthly outstanding loans and advances extended to the BPS in any calendar quarter shall not exceed 20% of the average monthly total outstanding loans in the previous quarter;
- Guarantees issued for the purpose of securing credit facilities to finance property development in any calendar quarter shall not exceed 20% of the total guarantees issued in the previous quarter; and
- Private debt securities (PDS) and commercial papers (CPs) issued to finance property development purchased by banking institutions in the primary market in any calendar quarter shall not exceed 20% of the total PDS and CPs purchased in the primary market in the previous quarter.

Additionally, guidelines on share holdings have been imposed in "Guidelines on Investment in Shares, Interest-in-Shares and Collective Investment Schemes (CIS)—Part C Paragraph 7.1 stipulates that a banking institution's investments in shares, interest-in-shares and CIS shall be subject to the following limits:

- The aggregate book value of investments in shares, interest-in-shares, CIS and immovable properties shall not exceed 50% of the banking institution's capital base; and
- The aggregate book value of the banking institution's investments in shares and interest-in-shares shall not exceed 25% of the banking institution's capital base.

EC 5 BNM's requirements that all material concentrations be reviewed and reported periodically to the Board are mentioned in the following guideline and manual:

- Best Practices for the Management of Credit Risk - Chapter 3 Part 2 Paragraph 2.16; and
- Credit Risk Management Manual - section: Introduction Part 2(a).

BNM's requirements for banks to have risk management policies and processes to establish thresholds for acceptable concentration of credit are embedded in the following guidelines and manuals:

- Best Practices for the Management of Credit Risk—Chapter 2 Part 4 Paragraph

	<p>3.1 and Chapter 3 Part 2 Paragraph 2.15(i) and Paragraph 2.16;</p> <ul style="list-style-type: none"> • Risk Weighted Capital Adequacy Framework (Basel II) —Internal Capital Adequacy Assessment Process (ICAAP) (Pillar II). • Manual for Examination of Banking Institutions - Topic D3: Concentration of Credits, Section D3.3 and Section D3.4. <p>AC1 BNM/GP5 establishes the following limits to manage large exposures:</p> <ul style="list-style-type: none"> • Loan to any customer is set at 25 percent of capital funds; • Overall limit for large loans is set at 50 percent of total credit facilities; and • Large loan is defined as total credit facilities granted to any customer which exceeds 15% of capital funds.
Assessment	Largely Compliant
Comments	<p>Generally speaking, laws, guidelines and supervisory practices are in place to ensure banking institutions' large exposures are prudently managed. Some enhancements can be made in the following areas:</p> <ul style="list-style-type: none"> • a more comprehensive definition of “a group of connected counterparties” including the notion of economic dependency; • a more active use of Pillar 2 to identify and assess credit concentrations; and • the alignment of the large exposure limits with international best practice (for example 25 percent instead of 35 per cent). <p>The BNM is planning to issue a revised guideline for credit concentrations: The revised guideline is expected to comprehensively address all the requirements of CP 10. Specifically, the enhancements to the guidelines include:</p> <ul style="list-style-type: none"> • Clear and specific risk management expectations on compliance with the prudential limits; and • Comprehensive guidance on determining interconnectedness of counterparties; • Review of prudential limits; and • Guidance on measurement of exposures to properly reflect exposures and ensure consistency. <p>The BNM confirmed that all banks are well below the current large exposure limits.</p>
Principle 11	<p>Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflicts of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>

Description	<p>EC 1: While the term “related parties” is not defined in Malaysian banking law, there are explicit prohibitions on loans to officers and directors, and strong restrictions on loans to “connected parties”. As defined in Section 2.1 of BNM/GP 6, connected parties are defined to include spouses and other defined close relatives of officers and directors; companies which control or are controlled by such connected parties; companies (and their subsidiaries) in which such connected parties are interested as a director, partner, executive officer, agent or guarantor; and subsidiaries of the licensed institution. Beneficial ownership is brought into the definitions by virtue of the definition in Section 6A of the Companies Act. As a result of a regulatory change in 2008, corporate shareholders (including various Government Linked Investment Companies) having interests between 20% and 50% of a bank or FHC were dropped from the definition of connected parties that had prevailed since 1999, unless that shareholder also had a director on the board of the bank or FHC. Accordingly, given the current extent of such investments in banks and FHCs, some substantial investors (and their subsidiaries and associated companies) were excluded from coverage.</p> <p>EC 2: Loans to connected parties (other than officers and directors, for which the absolute prohibition applies) are limited by nature and amount, and required to be made on terms no more favorable than similar exposures to non-related counterparties (Section 3.2 of BNM/GP6). BNM examiners review credit committee and Board minutes to identify specific facilities granted to connected parties and then review actual credit files for a sample of any such extensions.</p> <p>EC 3: Board approval is required for loans to connected parties under Section 63(d) of BAFIA and Paragraph 3.2(iv) of BNM/GP6. Requirement for the write-off of connected party exposures exceeding an amount specified by the bank are also subject to Board approval under Paragraph 4.5(iv) of BNM/GP6. In addition, Board members with conflicts of interest are precluded from the approval process under Paragraph 3.7 of BNM/GP6. BNM examiners review the process for compliance with the above requirements, including sample reviews of credit transactions to determine that they were approved by the Board or by a Committee of the Board operating under specifically delegated authority.</p> <p>EC 4: Under Paragraph 4.5(vi)(b) of BNM/GP6, connected parties are prevented from participating directly or indirectly in the deliberation and decision-making processes on transactions in which they have an interest. BNM examiners review processes of firms and board minute to validate that these provisions are followed.</p> <p>EC 5: The requirements to set limits on a general or case by case basis for exposures to connected parties are in Paragraphs 4.5(v), 5.1, and 6.2 of BNM/GP6. The limits established for aggregate outstanding credit exposures to all connected parties are set at the lower of 100 percent of capital base or 25 percent of outstanding credit exposures; these limits are lower than the limits for single counterparty or groups of counterparties (50 percent of total credit facilities). The requirement to deduct counterparty exposures from capital when assessing capital adequacy or to require collateralization is in Paragraph 10 of BNM/GP6.</p> <p>EC 6: The requirements for banking institutions to have policies and procedures to identify connected exposures; to monitor them through an independent credit review process; to report promptly exceptions to executive management and the board; and to have a process of independent on-going assessment of such transactions to be shared with the Board and senior management are spelled out in Paragraph 4 of BNM/GP6.</p>
-------------	---

	<p>BNM examiners review policies and practices through review of reports, minutes of the Board, Risk Management Committee, and Credit Committee, and on-site reviews.</p> <p>EC 7: BNM obtains regular reports (monthly, quarterly, and semi-annual) for compliance with connected lending requirements. The results of the assessment of these reports are included within the Monthly Progress Report provided to BNM senior management.</p>
Assessment	Largely Compliant
Comments	While the overall approach to connected lending is generally sound, the exclusion of some significant minority shareholders is a gap that should be addressed.
Principle 12	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring, and controlling country risk and transfer risk in their international lending and investment activities and for maintaining adequate provisions and reserves against such risks.
Description	<p>EC 1 The bulk of the country and transfer risk is held by the top 3 banks in Malaysia. In terms of exposure, the country risk is mainly to Singapore, Indonesia and Hong Kong. Overall, approximately 15 percent of bank assets consist of cross border exposures. The adequacy of a banking institution's policies and processes for country and transfer risk is assessed as part of the overall credit risk assessment in SuRF. Although there is no specific regulation dealing with country risk, BNM supervisors verify that banks have established a risk management framework that supports cross border lending and operations and that escalates international exposures to Senior Management and the Board. The assessors have reviewed supervisory documentation in this respect and were satisfied that the assessment as part of SuRF is adequate and comprehensive.</p> <p>EC 2 The nature and the extent of the supervisory assessment will be determined based on the risk profile of the banking institutions (see CP 19). BNM's supervisory assessment on the effectiveness of information systems, risk management systems and internal control systems are undertaken under the Information and Communication, Risk Management, Internal Audit and Compliance components of the Risk Management Control Framework (RMCF) assessment. The Conglomerates department issues quarterly briefings on country risk. The assessors reviewed the latest quarterly briefing.</p> <p>EC 3 BNM does not set fixed percentages for provisioning for each country. The banking institution itself sets its provisioning levels for all impaired exposures and the level of individual and collective provisions are to be reviewed regularly by each banking institution to ensure the amount of provisioning is consistent with its credit losses. The BNM supervisors review the provisions as part of their on site examinations. The BNM's Financial Surveillance, Economics department and the Specialist risk unit also closely monitor the situation in countries where the Malaysian banks have exposures. This includes information on emerging issues and adverse country or regional developments. During the recent crises in Europe and Middle East as well as the catastrophe in Japan, the Financial Surveillance Department provided early alerts and updates to the supervision departments on the developments taking place in these countries and the region. These macro level inputs are used as a basis for BNM supervisors to engage with their individual banking institution to ensure that their international exposures are adequately and effectively managed.</p> <p>EC 4 BNM receives periodic prudential returns on country risk in loans, investments and interbank exposures from banking institutions. These returns include exposures to foreign counterparties as well as loans or financing granted to Malaysian borrowers</p>

	where the proceeds were used to finance borrower's projects or operations in other countries. The BNM provided the assessors with numerous examples where the BNM has taken action as a result of increasing country risk in individual banks.
Assessment	Largely compliant
Comments	<p>Although the assessors are broadly satisfied that country risk is identified and assessed on a timely basis as part of the supervisory framework, there is a need for more explicit legal and regulatory requirements on banks in the area of country and transfer risk. With the growing internationalization of the Malaysian banking system, the BNM should expect that country and transfer risk be managed as a separate risk category.</p> <p>The BNM is to be commended for its comprehensive quarterly briefings on country risk.</p>
Principle 13	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor, and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	<p>EC 1 Market risk in Malaysian banks consists mainly of traded interest rate risk on government bonds and debt securities held in banks' trading books. Overall, the market risk capital charge represents less than 10 percent of the regulatory capital charges for the eight large domestic banking groups. That said, a number of foreign banks have substantial trading books and market risk capital charges can account for about 80% of capital. The BNM has issued detailed requirements for banks to apply the internal models approach for market risk, but until today all banks remain on the standardized approach.</p> <p>The RWCAF (paragraphs 5.21 to 5.27) state the qualitative requirements for policies and procedures that articulate roles and responsibilities relating to the identification, measuring and monitoring and control of market risk. To determine that each banking institution has in place the appropriate policies and processes on the roles and responsibilities in relation to risk management control functions, BNM conducts on site examinations. The BNM has six risk specialists for market risk The assessors reviewed the specific areas for market risk as well as the assessments BNM supervisors make during their examinations. They were satisfied that those were comprehensive and adequate. Moreover, banking institution have to submit their trading book policy statement for review by the BNM.</p> <p>EC 2 The RWCAF (paragraphs 5.21 to 5.27) contain the requirement to set market risk limits that are commensurate with the institution's size and complexity. These are assessed by the BNM supervisors during their onsite examinations. As part of off-site surveillance, BNM supervisors also review the monthly market risk capital adequacy framework (MRCAF) reports, ALCO and RMC"s minutes as well as the monthly risk management reports on issues pertinent to market risk to ensure continuous oversight by senior management. Should the level of Board and senior management oversight and governance fall below expectations, BNM supervisors would raise this inadequacy as a supervisory concern and reflect it in the rating for the Board and senior management in RMCF. Banking institutions are then required to address the supervisory concerns and respond to BNM with a list of corrective action plans within a BNM-specified timeframe. The assessors have reviewed the SuRF supervisory framework as well as a number of assessments in this area and were satisfied that the assessments reviewed were comprehensive and adequate.</p>

	<p>EC 3 BNM requires banking institutions to establish and maintain adequate systems and sufficient controls to capture all transactions as well as market data on a timely basis, as stated in paragraphs 5.12 to 5.14 of RWCAF. Paragraph 5.19 and 5.20 of RWCAF and paragraph 5.18 to 5.19 of CAFIB require banking institutions to establish and maintain policies and procedures for valuation adjustments or reserves arising from unearned credit spread, close-out costs, early termination and illiquid positions must be reflected in the computation of RWCR. The adjustments shall be subject to ongoing review.</p> <p>Internally, BNM conducts stress tests on banking institutions' trading book exposures based on market conditions. Examples of specific events include global financial crisis, European sovereign debt crisis and reversal of capital flows to gauge the potential impact of trading book exposures on earnings and capital. The stress test results are used, as a tool by BNM supervisors to engage in further discussions with banking institutions in assessing the institutions' trading book risk exposures. BNM supervisors also compare the stress test results submitted by banking institutions with these results in reviewing banking institutions' stress test scenarios to facilitate assessment of the appropriateness of assumptions used by the banking institutions.</p> <p>In terms of periodic validation or testing of the measurement systems, banking institutions are expected to validate the internal measurement system such as VaR model from the quantitative and qualitative aspects by a party independent from the model development team. Models are required to be reviewed frequently and are subject to back testing results. The requirements on model validation standards and model review have been set forth in Part D3.7 and 3.8 of MRCAF.</p> <p>EC 4 Since 1998, banking institutions have been required to conduct stress tests according to a set of generic assumption parameters prescribed by BNM and submit the results to BNM supervisors every quarter. Subsequently, BNM has revised and issued the Guidelines on Stress Testing–2007 requiring banking institutions to conduct internal stress tests to identify plausible events that could impact their capital and earnings positions. Banking institutions are required to submit the latest stress test results to BNM for review on a half-yearly basis. In addition, specific stress test expectations for market risk are also stipulated in Part D 3.6 of RWCAF</p> <p>AC 1 The RWCAF (paragraph 5.17 and 5.18) require banking institutions to conduct regular price verification on market data used to value trading book positions. Verification of market prices or model inputs should be performed by a unit independent of the business unit. BNM supervisors review the organization structure and terms of reference of the validation team to ensure its independence from the trading unit.</p>
Assessment	Compliant
Comments	<p>BNM is compliant with CP 13. The regulatory guidelines are comprehensive and clear with regard to the trading book.</p> <p>The assessors recommend more risk specialists are trained in market risk.</p> <p>The assessors recommend the risk specialist accompany the supervisor on onsite examinations for higher risk institutions.</p>
Principle 14	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies

	and processes to identify, measure, monitor, and control liquidity risk and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	<p>EC 1: All banking institutions are required to comply with BNM’s Liquidity Framework (LF)—a framework that the assessors consider to be reasonable and conservative. The LF requires all banks to maintain sufficient liquid assets to ensure that they have a net liquidity surplus position for the next 30-day period from the reporting date, after taking into consideration liquidity shocks in the form of a prescribed percentage of outflows of a bank’s total deposits. Banks are required to submit their liquidity positions to the BNM on a monthly basis. The LF also requires banks to determine for a period of up to 1 year, the maturity profile of on-balance sheet assets and liabilities and off-balance sheet commitments.</p> <p>Under the LF, a bank’s liquidity is assessed from three levels:</p> <ul style="list-style-type: none"> • The first level assesses the sufficiency of a banking institution’s liquidity in the normal course of business stretching from 1 week (3 days for investment banks) to a 1 year horizon. The on- and off-balance sheet assets and liabilities are slotted into the liquidity maturity buckets based on behavioral assumptions as prescribed in the framework; • The second level assesses whether or not a banking institution has the capacity to withstand prescribed liquidity shocks after considering the stock of liquefiable assets adjusted with an appropriate level of haircuts; and • The third level assesses a banking institution’s general funding structure to determine the degree of dependency on certain volatile funding sources. <p>A regulatory “net compliance surplus” is achieved when the summation of liquidity gap positions under normal circumstances with the discounted value of high-quality liquefiable assets, exceeds the prescribed liquidity shocks for the next 30-day period after the reporting date. BNM supervisors engage with the senior management of banking institutions that fail to meet the compliance requirement and require such banks to put in place a remedial plan with a clear timeline to comply with the liquidity requirement.</p> <p>EC 2: In order to confirm that these liquidity strategy, policies and processes have been approved and deliberated by the Board, BNM supervisors review Board minutes and papers on liquidity management strategy, policies and procedures of the bank.</p> <p>As confirmed by assessor review of supervisory documents, BNM supervisors review in detail for banking institutions such key areas as:</p> <ul style="list-style-type: none"> • Liquidity gap limits for both local currency and foreign currency (FCY) for banking institutions with material FCY operations; • The diversity and stability of funding sources taking into account the business model of the bank—e.g., recognizing that banks with heavy reliance on wholesale funding to fund a big portfolio of medium to long term loans are more vulnerable than banks with the same funding profile but with a big portfolio of short term loans and liquid assets;

- Liquidity stress test;
- Contingency Funding Plan (CFP);
- Parties responsible for the bank's liquidity management; and
- Escalation and corrective procedures when non-adherence occurs.

For banking groups, BNM supervisors assess whether the liquidity risk profiles of banking subsidiaries are monitored and controlled at the group level. BNM supervisors review the parent bank's ALCO report to determine that the liquidity profiles of banking subsidiaries are tabled at the parent bank's ALCO meeting. However, no such ongoing review of consolidated liquidity takes place for FHCs.

For banking groups with overseas operations, BNM supervisors assess the extent of reliance of foreign branches or subsidiaries on funding from their parent bank. When there is a high reliance of funding from the head office or parent bank, BNM supervisors review internal management reports e.g., liquidity gap, funding sources, liquidity ratios, liquidity stress test reports etc. tabled at ALCO to determine that the liquidity strategies are consistent with the Board-approved strategies, and that compliance with the policies is monitored by the compliance department or the risk management department. BNM supervisors look for further confirmation that senior management has put in place the proper guidelines on liquidity operations by engaging with the funding desk dealers who are responsible for the day-to-day liquidity operations to assess their awareness of the Board-approved policies and procedures.

BNM supervisors review the bank's board papers and minutes to determine that key information such as liquidity gap positions against limits, key liquidity ratios, stress testing and balance sheet analysis are tabled to the Board or BRMC and are well-deliberated. BNM supervisors also review the compliance and risk management reports tabled to the Board or BRMC for an independent assessment of the effectiveness of the liquidity risk strategies and compliance with the Board-approved limits and policies.

EC 3: BNM supervisors review policies and processes established by the ALCO for managing liquidity risk such as:

- The policies on composition and maturity of assets and liabilities;
- The diversity and stability of funding sources;
- The approach to managing liquidity in different currencies, across borders, and across business lines as well as legal entities; and
- The assumptions on the liquidity and marketability of assets.

A focus of the review is to assess whether the policies are consistent with the overall risk appetite set by the Board and commensurate with the nature, scale and complexity of the bank's operations and its organizational structure. BNM supervisors also determine that the risk management department has signed off on such policies.

BNM supervisors verify that limits as approved by the Board such as gap limits or cumulative gap limits have been incorporated into the measurement system to manage the liquidity risk exposures. BNM supervisors review the bank's organization structure to determine that independent liquidity risk management and compliance units have been established to monitor the liquidity risk and ensure compliance to policies. Additionally, in assessing the implementation of limits, policies and procedures, BNM supervisors engage with the middle management in the treasury and risk management departments to assess their awareness and understanding of the strategies, limits, policies and procedures that have been established by the Board and ALCO. BNM supervisors also determine that the ALM operations are audited at least on an annual basis by internal auditors to ensure that the policies and procedures have been adhered to. BNM supervisors also review the ALCO reports and minutes to determine that pertinent information for liquidity risk management such as the liquidity gap positions, funding structure, key liquidity ratios, compliance and risk management reports are tabled to ALCO for deliberation.

EC 4: Net funding requirements are assessed in the context of a broader review of how other risks could impact the need for funding. BNM supervisors: review the composition of ALCO to determine representation from business units, risk management (representing, credit market and operational risk), the economics department, finance and operations to ensure breadth of the decision-making and full acceptance; review the ALCO minutes to determine that issues, which could affect the confidence of fund providers, are deliberated at ALCO and pre-emptive measures are taken to mitigate any potential liquidity impact; and review the deliberations in the Risk Management Committee

BNM supervisors review the bank's liquidity stress test policies to determine that the bank considers various scenarios, including both institution-specific and general market disruptions. Within each scenario, BNM supervisors determine that the policies address the run-off rates of customer deposits and wholesale deposits and haircuts to various securities. BNM supervisors assess the rigor of assumptions used in determining the run-off rates for funding sources and haircuts for liquid assets; and ensure that assumptions are not too bullish. BNM supervisors also review the liquidity stress test of the overseas branches or subsidiaries to determine that the parameters under each scenario take into consideration local regulatory and market conditions.

In determining that stress test results are being appropriately used by the bank, BNM supervisors:

- review the liquidity risk limit setting process of the institution to verify whether the bank uses the results of the stress test in determining its liquidity risk limits;
- review the ALCO minutes to determine that the results of the stress test are discussed thoroughly by senior management and form the basis for taking mitigating actions to limit bank's exposures, build up liquid assets or adjust its liquidity profile to fit its risk tolerance; and
- assess whether the contingency funding plans are closely integrated with the liquidity stress scenarios of the bank.

For each banking group, BNM supervisors also assess that the parent bank conducts a consolidated stress test and tables the stress test results at ALCO. However, no such consolidated stress test is required for FHCs.

BNM supervisors review banking institutions' liquidity policies to determine that the policies address diversification and concentration risks by establishing limits or ratios to prevent concentration of funding to top depositors, by maturity and from volatile sources such as reliance on the swap market or inter-bank market to fund local assets.

EC 5: BNM supervisors require the banks to have proper liquidity risk management policies governing the FCY operations. BNM supervisors review monthly ALCO reports which contain liquidity gap reports of the bank in local currency and FCY for overseas branches or subsidiaries. Additionally, banks are required to submit to BNM both the local currency and FCY liquidity gap positions as required under the LF submission. Malaysian banks' FCY assets are relatively small, accounting for only about 10-15% of total banking assets. The FCY maturity transformation of the banking industry is also small mainly arising from short term treasury activities e.g., FX swap and short term FCY interbank borrowing and lending instead of core banking activities such as medium to long term loans in FCY. For banks with material FCY operations, BNM supervisors review the ALCO report to determine that a separate liquidity gap analysis and limit for each significant FCY is established.

EC 6: BNM supervisors determine that the ALCO has deliberated and the Board has approved the CFP by verifying with the minutes of ALCO and Board meetings. BNM supervisors review the CFP to determine it:

- Is commensurate with a bank's risk profile and role in the Malaysian financial system;
- Articulates clear escalation procedures detailing when and how each of the plans can and should be activated and the lead time needed to tap additional funds from each of the contingency sources under stress ;
- Is designed to be closely integrated with the results of the scenarios and assumptions used in the bank's stress test;
- Provides clear specification of roles and responsibilities including the authority to invoke the CFP; and
- Addresses when and how to contact BNM supervisors.

For banking institutions with overseas branches or subsidiaries, BNM supervisors determine that separate CFPs for the branches or subsidiaries have been developed, reviewed by ALCO at head office and approved by the Board by verifying against the ALCO and Board minutes.

AC 1: For banks with material FCY operations, BNM supervisors review the ALCO report to determine that a separate liquidity gap for each significant FCY is established. BNM supervisors require the bank to have proper liquidity risk management policies governing the material FCY operations as described above.

	<p>BNM supervisors engage senior management and review the liquidity risk limit setting process for material FCY operations to determine that the results of the stress test have been considered in determining the liquidity risk management limits such as the liquidity gap limits and concentration to funding sources of such material FCY operations.</p> <p>AC 2: BNM supervisors review banking institutions' liquidity policies to determine that the policies address diversification and concentration risks by establishing limits or ratios to prevent concentration of funding to top depositors, maturity and volatile sources such as reliance on swap market or inter-bank market to fund local assets. BNM supervisors verify that those limits and ratios are being monitored by an independent unit and reported to ALCO by reviewing the risk management reports and ALCO papers.</p> <p>BNM supervisors review the liquidity management policies of the bank to determine that the institution has established a policy to govern the classification of liquid assets. BNM's LF specifies criteria for instruments to be qualified as liquefiable assets for regulatory compliance purposes as well as prescribes regulatory liquidity haircuts for less liquid liquefiable assets. BNM supervisors review the composition of liquid assets through the banking institutions' monthly submissions on BNM's LF to ensure there is no over-reliance on low-quality assets to be liquidated.</p>
Assessment	Largely Compliant
Comments	<p>The regime for bank liquidity risk management is a sound one, but improvements could be made in the application of the regime to FHCs.</p> <ul style="list-style-type: none"> • BNM supervisors need to conduct ongoing reviews of FHC consolidated liquidity. BNM needs to require that an FHC conducts a consolidated liquidity stress test and table the stress test results at ALCO.
Principle 15	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor, and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
Description	<p>EC 1The requirement for banking institutions to have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk adequate for the size and complexity of operations is set out in Paragraph 4.4 of the RWCAF, which states that: "Regardless of the approach adopted for the operational risk capital charge computation, banking institutions shall have in place internal operational risk management framework that is commensurate with the nature, complexity and sophistication of their business activities."</p> <p>Other prudential guidelines relevant to the management of operational risk include:</p> <ul style="list-style-type: none"> • Guidelines on Corporate Governance for Licensed Institutions, which among others, outline the expected roles and responsibilities of the Board in the overall stewardship of the institution. This includes ensuring that the operations of the institution are conducted prudently within the framework of relevant laws and policies as well as ensuring that the institution establishes comprehensive risk

	<p>management policies, processes and infrastructure to manage the various types of risks;</p> <ul style="list-style-type: none"> • Guidelines on Introduction of New Products, which incorporate sound risk management practices in the management and control of product risks by ensuring appropriate assessment and mitigation of risks during product development and marketing stages; • Guidelines on Business Continuity Management, which set out the expectations for Licensed Institutions to adopt sound and effective business continuity procedures and practices to improve their resilience and be prepared for any eventualities; • Guidelines on Management of IT Environment, which serve as the minimum standard for governance and management of IT environment as well as for technology-related risks and information security; and • Guidelines on Outsourcing of Banking Operations, which require banking institutions to comply with certain conditions and safeguards before they are allowed to outsource non-critical operational functions. <p>The supervisory assessment of banking institutions' risk management is embedded in the supervisory framework. Supervisory assessments on inherent risks and quality of operational management and risk management control functions are documented in the Review Notes for each respective significant activity. Every risk management control function would also have its respective Review Notes that document the overall performance of the functions in overseeing the enterprise-wide risk management activities. The assessors reviewed a number of risk management assessments for operational risk prepared by the BNM supervisors and confirm these are comprehensive and adequate.</p> <p>All banks in Malaysia are applying the Basic indicator approach for operational risk. Two banks are in the process of applying for the standardized approach. The BNM has 3 operational risk specialists. That said, within the supervisory divisions (conglomerates division and banking supervision division), 17 supervisors also have an IT background and are in the first line of call for IT related issues.</p> <p>EC 2 BNM GP1 outlines the major responsibilities of the Board including ensuring that the licensed institution establishes comprehensive risk management policies, processes and infrastructure to manage the various types of risks. More specifically, GP1 requires the Board to approve and periodically review the risk management capabilities of the licensed institution to ensure that they are able to support the institution's business expansion.</p> <p>The RWCAF further requires the Boards of banking institutions adopting TSA to be actively involved in the oversight of the operational risk management framework that encompasses operational risk management structure, policies, procedures and processes. The key expectations on the Board include:</p> <ul style="list-style-type: none"> • Provide senior management with clear guidance and directions regarding the principles underlying the operational risk management framework; • Review and approve firm-wide operational risk management framework to manage operational risk as a distinct risk category; • Ensure proper institutionalization, review and approval of operational risk
--	--

	<p>appetite and tolerance e.g., the setting of thresholds for collection and reporting of operational loss data and transfer of risk through insurance;</p> <ul style="list-style-type: none"> • Ensure that the banking institution’s operational risk management framework is subject to effective review by appropriately trained and competent internal audit staff; and • Consistently place emphasis on the importance of strong risk and control culture. <p>The Board is ultimately responsible to ensure effective implementation of strategies, policies and processes, thus any supervisory concerns are highlighted to the Board for attention and further actions. BNM formally engages with the Board of every banking institution at least on an annual basis to communicate supervisory concerns and to update on regulatory changes and expectations on the Board.</p> <p>EC 3 The effectiveness of the strategies, policies and processes for operational risk management is assessed and validated through supervisory review process undertaken for each significant activity as well as during thematic reviews e.g., corporate governance, risk management, compliance and anti-money laundering. In addition, BNM supervisors periodically (monthly/ quarterly basis) obtain and review the following documents/ reports/ information relating to operational risk:</p> <ul style="list-style-type: none"> • Operational risk management information as reported to relevant senior management committees, which includes operational risk profile and dashboard that comprise heat maps, as well as analysis of key operational risk events and losses; • Minutes of meetings of the Operational Risk Committee, Executive Risk Committee or Management Committee at the senior management level to determine if pertinent matters on operational risk are adequately deliberated. • Supervisory focus is on the usage of operational risk information by senior management to understand key and emerging operational risks affecting the banking institution and establish, allocate resources and monitor corrective actions to address any concerns; • Compliance and internal audit reports on banking institutions’ compliance with regulatory requirements and internal policies and procedures; and • Data from operational risk loss event submission using the Electronic Fraud Information Database System (eFIDS). <p>EC 4 BNM has issued the Guidelines on Business Continuity Management (BCM Guidelines), which among others require banking institutions to:</p> <ul style="list-style-type: none"> • Have in place a comprehensive business continuity management framework that includes a business continuity policy; • Establish a comprehensive business continuity management program to formulate, implement and test business continuity plans; • Review and update business continuity plans and disaster recovery plans continuously to reflect changes in operating environment; and • Provide the Board with sufficient information to enable them to discharge their responsibilities under the BCM Guidelines. <p>The BCM Guidelines specify that business functions that involve, among others, among others, large-value and time-sensitive payment instructions, clearing and settlement of</p>
--	---

material transactions and provision of essential banking services and payments such as cash withdrawal, deposits and remittances, must be defined as critical business functions that must continue in the event of major disruptions, and hence must be given priority for recovery. In this respect, banking institutions are required to observe the standard Maximum Tolerable Downtime (MTD) and Recovery Time Objective (RTO) for the following services and system:

- Inter-bank real-time gross settlement system (RENTAS) – MTD of 1.5 hours;
- Cheque clearing operations and system – MTD of four (4) hours;
- Retail branch operations – MTD of four (4) hours; and
- Card-based systems, which include credit and Automated Teller Machine (ATM) – RTO of four (4) hours.

Supervisory reviews on the quality and comprehensiveness of banking institutions' business resumption and contingency plans are conducted as part of the review of individual significant activities and as thematic reviews on an enterprise-wide basis, as elaborated in previous sections. Assessment of business resumption and contingency plans is essentially based on the requirements of the BCM Guidelines, where BNM supervisors would first conduct desktop review of the framework, policies, manual and other related documentation and reports e.g., internal audit and BCP test reports. This is followed by a series of engagements and follow-up discussions with the accountable persons and stakeholders within the BCM framework, e.g., members of the BCM Committee, dedicated BCM function and BCM coordinators for the key business and operating functions. BNM supervisors would also conduct visits to the recovery sites to assess the infrastructure, facilities and logistical readiness.

EC 5 Guidelines on Management of IT Environment (GPIS1) were issued by BNM to serve as the minimum standards for governance and management of IT environment as well as for managing technology risks and information security. The scope of GPIS1 includes among others, Board and management oversight, system security, system development, IT operations, communications network and business resumption and contingency plan.

In addition to IT audit reports and post-test analysis of IT contingency plans testing, GPIS1 also mandates the reporting of serious system security breaches, down times and performance degradation. Such security breaches and frauds (e.g., cyber attacks and internet banking/ card services fraud) are monitored by BNM, for which it maintains close coordination with the National Security Council. These surveillance mechanisms keep BNM constantly updated on emerging IT risks within the banking industry.

EC 6 Banking institutions are required to immediately report material operational risk events and losses, which include frauds, regulatory breaches and business disruptions due to external events. (see User Guidelines on the transmission of data to BNM). The BCM Guidelines stipulate that banking institutions are required to submit among others, executive summaries of BCP and DRP audit reports, while GPIS1 mandates the reporting of serious security breaches, system down time and degradation in performance that critically affect the banking institutions.

Reporting of operational risk loss events in accordance to Basel II's loss taxonomy is mandated to TSA banks (Section 69, 71 and 79 of BAFIA), while banks adopting the

<p>Basic Indicator Approach (BIA) are highly encouraged to do so. As at December 2011, 48% of banking institutions have been reporting their operational risk loss events to BNM.</p> <p>The Electronic Fraud Information Database System (eFIDS) is a platform that facilitates the reporting of all fraud incidences in the banking system. eFIDS reporting has been made mandatory for all institutions in banking sectors, with the exception of investment banks.</p> <p>EC 7 Paragraph 4.1 of Part C of BNM's RWCAF (Risk Weighted Capital Adequacy Framework) Guidelines defines operational risk. The definition is in line with Basel II and includes legal risk. Under the supervisory framework, the key assessment criteria include whether the assessment whether legal and compliance risk is included in the definition of operational risk.</p> <p>EC 8 Banking institutions are allowed to outsource non-core functions as a means to improve operational flexibility, minimize the need for capital investment and enable greater focus to core business and enhance efficiency levels. BNM Guidelines on Outsourcing of Banking Operations (Outsourcing Guidelines) outline a list of conditions that banking institutions must comply with before being allowed to outsource any non-core functions.</p> <p>These include:</p> <ul style="list-style-type: none"> • Due diligence review on the capabilities and expertise of the outsourcing vendor prior to the selection; • Approval from the Board to outsource the function; • Written undertaking by the outsourcing vendor to comply with the secrecy provision; • Service agreement with the outsourcing vendor should include a clause on professional ethics and conduct in performing their duties. The service agreement should also clearly define the roles and responsibilities of the outsourcing vendor; • The service agreement clearly stipulates the right to terminate the service if the outsourcing vendor fails to comply with the conditions imposed; • Proper reporting and monitoring mechanisms to ensure that the integrity and quality of work conducted by the outsourcing vendor; • Regular testing and review of the work done by the outsourcing vendor; • The right to inspect the books and internal control environment of the outsourcing vendor; and • Availability of contingency plan in the event that the arrangement with the outsourcing vendor is suddenly terminated. <p>The BNM has inspected the sites of several outsourcing providers.</p> <p>Off-shoring i.e. outsourcing of non-core banking activities to service providers located outside Malaysia requires prior approval from BNM. Approval would only be granted upon satisfactory assessment on internal controls for the outsourced operations, compliance with home regulations and adequacy of monitoring and oversight by the banking institution.</p> <p>AC 1 BNM's supervision of banking institutions is conducted on a consolidated basis which includes assessments of all material activities/entities within a banking group (subsidiaries & branches) both in Malaysia and cross border. Supervisory work on the</p>

	adequacy of operational risk management follows the same principle, as the framework, policies and procedures of a banking group are expected to be cascaded down to subsidiaries and branches. When reviewing the implementation of operational risk management policies and processes of a banking group, BNM supervisors assess the adequacy of oversight and monitoring by the group's Board, senior management and operational risk management function over the implementation at the subsidiary levels. This is validated through separate supervisory assessments on the adequacy of operational risk management policies and processes at the subsidiaries (see also CP 24)
Assessment	Largely compliant
Comments	<p>Although high level operational risk management requirements are generally in place and adhered to, the assessors recommend</p> <ul style="list-style-type: none"> • the release of more detailed supervisory expectations • the training of more supervisors in the operational risk specialist risk stream • operational risk specialists attend on site examinations for higher risk institutions. <p>BNM is currently developing an Operational Risk Reporting System to upgrade eFIDS into a full-fledged operational risk event and loss reporting system, for increased surveillance capability as well as for information sharing with the industry. This will include revision to the fraud taxonomy to cater for fraud events that are inherent in investment banking activities. The system is expected to be operational in the first quarter of 2013.</p> <p>The BNM is already addressing the first recommendation by drafting the Operational Risk Management Guidelines. The guidelines will also mandate the reporting of all operational risk loss events.</p>
Principle 16	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well-defined strategy that has been approved by the board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Description	<p>EC 1 BNM has yet to issue a specific regulation on interest rate risk in the banking book. The risk category will also be covered by Pillar II implementation and the ICAAP process, but the first ICAAPs only need to be submitted by March 2013 by the banks. Nevertheless, BNM supervisors determine that the bank's Board reviews and approves, at least annually, significant risk management policies and practices and obtains assurance that these are being adhered to. This entails conducting interviews with senior management of treasury, risk management department and ALCO support unit to determine whether the Board has established new policies or has reviewed existing IRRBB policies. BNM supervisors also conduct review of the minutes of the Board or Board Risk Management Committee meetings for further validation. Consequently, absence or significant deficiency on Board approvals and review processes will be raised as an area of supervisory concern.</p> <p>EC 2 To ensure ALM strategies are developed and implemented effectively, BNM supervisors carry out the following processes:</p> <ul style="list-style-type: none"> • Review ALCO meeting minutes to ensure that IRRBB strategies and

	<p>performance of the strategies are discussed. BNM supervisors also review policies and guidelines issued by ALCO to relevant business units and the treasury department to manage IRRBB associated with their business strategies;</p> <ul style="list-style-type: none"> • Review and assess internal management reports pertaining to IRRBB to ensure senior management has developed the necessary measurement tools to capture IRRBB risk such as interest rate gap reports; • Review reports prepared by independent risk units for evidence of IRRBB limits monitoring and stress testing; • Verify interest rate exposures reports escalated to ALCO by treasury and risk management departments to ensure correct information is escalated; • Review internal audit reports carried out on the ALM functions which have been tabled to the Board Audit Committee to ensure internal controls, processes and procedures put in place are adhered to and ensure senior management has resolved critical issues satisfactorily through follow up with them; and • Discuss with the treasury personnel and members of ALCO to gauge their understanding of Board approved policies, procedures, limits and control as well as awareness of interest rate exposures and Board and senior management strategies with respect to IRRBB. <p>Through off-site surveillance, BNM supervisors ensure senior management maintain continuous oversight on the interest rate risk by reviewing the bank's internal management reports, ALCO minutes, quarterly interest rate duration weighted gap (DWG) reports and risk management reports relating to IRRBB.</p> <p>The assessors reviewed risk assessments for a number of banks and were satisfied with the depth and completeness of the supervisory procedures for IRRBB.</p> <p>EC 2 BNM expects banks to employ measurement models and systems that are commensurate with the size and complexity of their operations. Banks using internal models to measure IRRBB are expected to perform model validations and conduct model reviews at least on an annual basis by a party independent of the model development. BNM supervisors then review such reports on model validations and model reviews to ensure comprehensiveness of the measurement models. In reviewing the reports, BNM supervisors seek evidence that:</p> <ul style="list-style-type: none"> • There are proper internal controls and governance in place relating to data and positions input and mapping, model validation and review requirement; • The measurement model captures all relevant and significant interest rate exposures of the banking institution; • The measurement model is premised on appropriate model assumptions which have been sufficiently tested and deliberated; and • Model validation and model review reports have been deliberated by the Board and senior management. <p>BNM supervisors also seek evidence that the use of the model has been recommended by senior management and approved by the Board.</p> <p>To determine that the bank's limits reflect the risk strategy of the institution, BNM supervisors discuss with the senior management to have a clear understanding on the IRRBB strategies employed and the target or tolerance level in terms of the intended impact on earnings or capital the bank intends to achieve. From the intended risk profile</p>
--	---

generated by the strategies, BNM supervisors determine the potential IRRBB impact and verify the impact against the target set by the Board. BNM supervisors also review the relevant minutes of ALCO and Board meetings to ensure adequate deliberations on the limits structure. BNM supervisors ensure that appropriate limit structures to manage the interest rate exposures are put in place by verifying the limits against the gap reports monitored by the independent risk units.

EC 3 BNM requires banking institutions to perform internal stress tests to gauge the potential impact of adverse interest rates movements as set out in the guideline issued by BNM in 2007 namely Guideline on Stress Test.

In practice, banks conduct internal stress tests on a monthly basis or at least on a quarterly basis for escalation to the Board Risk Committee and ALCO. For IRRBB, BNM supervisors review the internal scenarios and assumptions used to ensure they cover various scenarios of different magnitude of severity and their impact on earnings and capital. BNM supervisors review the stress test to identify potential areas of concern and use the information in planning for on site examinations. Further, BNM supervisors compare the stress test results submitted by the banks with the results of the quarterly DWG regulatory reports analysis to better understand the banks' IRRBB profile and strategies and assess the appropriateness of the assumptions used and the impact on earnings and capital. These comparisons facilitate better discussions between the BNM supervisors and the banks in the oversight of IRRBB.

AC1 On a monthly basis, banks submit to BNM supervisors internal management reports tabled to ALCO which include among others, the measurement and internal stress test on IRRBB based on the bank's own assumptions. In addition, banks are also required to submit to the BNM supervisors the quarterly DWG regulatory reports where interest rate exposures are slotted into re-pricing buckets based on the treatments prescribed by the BNM supervisors. The net exposures in each repricing bucket are translated into interest rate sensitivity impact by applying a standardized shock to determine the impact on the EVE of the bank. Based on the DWG report, the BNM supervisors monitor the level of IRRBB exposures of the bank. In addition, the BNM supervisors monitor and assess the IRRBB exposures in the banking industry which allows them to identify outlier institutions or segments with relatively higher IRRBB exposure, for more detailed assessment and to consider various supervisory tools to address the high IRRBB.

AC 2 Following the issuance of the ICAAP framework to the industry in December 2011, BNM requires banks to allocate internal capital to buffer for Pillar 2 risks and BNM supervisors will review and assess the bank's internal capital assessment process at least on an annual basis to ensure that it adequately captures the IRRBB.

AC 3 In Malaysia, banks stress interest rate positions predominantly using instantaneous parallel shifts and yield curve steepening ranging from 50bps to 300bps. As specified under the stress testing guideline, the regulatory stress test must be communicated to the board, senior management, and Risk Management Committee to enable them to consider the implications on the bank's strategy or business profile and consider appropriate response. Further, the guideline requires the banks to submit extracts of minutes of the Board and Risk Management Committee meetings that were convened to deliberate results of the stress test for off-site supervisory review. During on-site examinations, BNM supervisors engage with the senior management and the risk management department on the stress test result carried out on IRRBB to determine

	<p>whether the limits and policies on IRRBB are set after considering, among others, the stress test results. As explained in EC3, stress test results are required to be escalated to ALCO and the Board for deliberation which consequently could result in review of policies, procedures and limits as well as business strategies if the risk is viewed as too high.</p> <p>AC 4 The independence of risk management function is assessed under the Risk Management component of the SuRf. BNM supervisors assess the independence of risk management function by reviewing the reporting structure of the unit that independently monitors the IRRBB, to ensure that it is independent of the risk taking function. Additionally, BNM supervisors discuss with the key staff in the unit to ensure that they are independent of the treasury operations which could undermine their independence. In the industry, independent risk management functions of IRRBB are undertaken by the Risk Management Unit with direct reporting line to the Board Risk Committee.</p> <p>The assessors have reviewed a number of risk assessments for interest rate risk in the banking book and are comfortable with the depth and the comprehensiveness of the supervisory procedures performed.</p>
Assessment	Largely compliant
Comments	<p>The assessors reviewed the assessment of IRRBB as part of their review of a number of supervisory files and were satisfied with the depth and scope of the individual institutions' and horizontal reviews. That said:</p> <ul style="list-style-type: none"> • There is currently no regulation addressing IRRBB; • Feedback from banks indicated this is area why supervisory expectations need to be clarified; and • More specialists need to be trained in IRRBB and they should attend the onsite inspections for higher risk institutions.
Principle 17	<p>Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
Description	<p>EC 1: BNM/GP1 establishes the governance and general control expectations for commercial banks. The Board must ensure there are effective internal control and risk management processes with independent and appropriately staffed internal audit and compliance functions; must establish an Audit Committee to provide direct oversight of the internal audit function; and establish policies and procedures to govern conflict of interest situations and related party transactions.</p> <p>Among the responsibilities cited for senior management are: overseeing operations and providing leadership and direction for control processes; implementing Board policies by establishing effective internal control systems; and ensuring that appropriate people are hired and then are appropriately trained and compensated in order to carry out effectively</p>

their internal control responsibilities.

EC 2: The BNM supervisor considers whether the banking institution's control system methods, records and procedures are appropriate in relation to the size, organization and ownership characteristics, business activities and operational complexity and risk profile, taking into account legal and regulatory requirements; and changes in the business or operating environment.

Under SuRF, internal controls are assessed on a business-by-business basis (i.e. by significant activities—with the strongest of controls expected in complex trading activities) to determine the quality and effectiveness of the banking institution's operational management and the independent assurance functions including internal audit, compliance and risk management.

EC 3: In addition to the responsibilities of the Board and senior management as outlined in EC 1, BNM/GP1 places the responsibility on the Board to set corporate values. The Board has to ensure a culture that emphasizes the importance of internal controls is established and maintained in the banking institution. The guideline further requires the Board to approve corporate values and clear lines of responsibility and accountability for itself, senior management and employees. The guideline also requires the Board and senior management to understand the underlying risks arising from the banking institution's business activities. In addition to ensuring that a board has the appropriate mix of skills, BNM also provides directors with training programs in such areas as corporate governance, risk management, and financial reporting. Discussions with bankers confirmed that these programs have been very useful in ensuring that directors better understand their roles and responsibilities.

EC 4: BNM has the power to reject candidates for appointment or re-appointment as CEO and as directors, if an individual is not determined to meet the fit and proper test. (In fact in the 2010-2011 period, it rejected 9 candidates.) It also has during the re-appointment process the authority to approve an individual but with a shortened tenor—e.g., 1-2 years vs. the normal 3 years. (This has been done on 24 occasions in the past two years.) BNM can also re-designate an independent director as non-independent, given for example long association with the bank (done twice in the past two years). It can also specify a higher proportion of independent directors than the 1/3 specified in BNM/GP1 or require the Board to review its composition (done 6 and 8 times, respectively, in the past two years).

EC 5: BNM evaluates the quantity and quality of resources in the back-office, risk management, compliance, and internal audit functions through a review of information from budgets, from analyzing qualifications and experience of key personnel in those areas, and through engaging with key personnel in a variety of meeting forums. BNM utilizes its Risk Specialists in helping to review technical areas.

EC 6: Generally, the supervisory assessment of the banking institution's compliance function entails a review of the organization structure of the compliance function and its reporting line to ensure that it is independent from business units, an evaluation of the banking institution's compliance framework, policies, procedures and tools (e.g., compliance checklist) to determine its comprehensiveness and conformance with sound practices, a review of the scope and mandate of the compliance function of banking groups and assess the effectiveness of its oversight over the group's entities, and sampling to test for effective implementation of the above policies and procedures. The BNM supervisor selects several key controls (e.g., loan approving authorities, customer

due diligence and loan disbursement conditions) and checks for compliance with the banking institution's policies and procedures. Supervisors also engage with compliance personnel to see if practices at the banking institution may vary from that in written procedures. Conversations that assessors have had with bankers attest to the extent of direct communication of compliance personnel with BNM supervisors, and the directness of the message conveyed on expected extensive compliance review of transactions.

EC 7: BNM/GP1 requires the establishment of an independent internal audit function and BNM/GP10 establishes a series of expectations; these include internal audit evaluating a) compliance with internal policies and risk controls and b) the adequacy and effectiveness of the risk management, internal controls and governance process. The BNM supervisors assess the effectiveness of internal audit through a review of the Audit Charter to assure appropriate coverage of its responsibilities, the scope of audit programs, and a sample of internal audit reports on key activities. Discussions with banks, and review of supervisory documents, confirmed to the assessors that these kinds of steps are being taken in practice.

EC 8: BNM looks to determine whether the head count and level of competence of the internal auditors are commensurate with the risk profile of the banking institution. Where the banking institution is engaged in high risk or complex activities (e.g., securities trading and derivatives), the BNM supervisor expects internal audit to encompass a higher head count and technical expertise in the relevant area. BNM reviews the internal auditors' academic or professional qualification, experience and training. The training program is evaluated to ensure it is appropriately focused. The BNM supervisor also gauges the competence of the internal auditors via face-to-face interactions during meetings and engagements.

BNM supervisors review the Audit Charter to determine internal audit's reporting lines including the parties to which it is accountable—ensuring that it reports directly to the Audit Committee and has free access to the full Board. In cases where internal audit also reports administratively to the CEO, there is a review to ensure that its independence is not impaired/diluted in substance, by reviewing whether audit findings are subjected to clearance by the CEO or other layers of management;

BNM looks to determine the authority and status accorded to the internal auditors. Supervisors check the breadth of the Audit Charter and compares the position of the Chief Internal Auditor with other members of management to determine whether the person has sufficient status and clout to raise audit issues and challenge management. The BNM supervisor interviews the Chairman of the Audit Committee and if necessary, heads of business units, in order to gauge the level of respect accorded to the internal auditors in practice. They review minutes of the Audit Committee for indications whether internal audit is able to constructively challenge management on audit issues.

BNM will also assess whether Internal Audit can and does review outsourced functions. The assessors confirmed with BNM personnel that reviews of major outsource providers are done, such as ones in Malaysia providing services to multiple banks.

AC 1: BNM/GP1 requires that the Board collectively possess a mixture of core competencies in finance, accounting, legal, business management, information

	<p>management, and information technology, as spelled out in Section 2.61 of BNM/GP1.</p> <p>AC 2: Under BNM/GP1, the internal auditors are to be under direct supervision and authority of the Audit Committee, with full access to that Committee and with their performance and compensation evaluated by that Committee. Under BNM/GP10, the Chief Internal Auditor should have the authority to communicate directly with the Board, with its Chairman, and with regulators.</p> <p>AC 3: BNM/GP10 requires that the Audit Committee include only non-executive directors, with the majority being independent directors. BNM has the authority to determine that some non-executive directors (such as individuals with a long history with a bank) are not independent.</p> <p>AC 4: The guidelines on Fit and Proper for Key Responsible Persons (issued by BNM on March 10, 2011) require the Nominating Committee to remove a key responsible person (i.e., a director, the CEO, and any person performing a senior management function) if that person is judged to be no longer fit and proper for that person. If such action is taken, the Board is required to inform BNM.</p>
Assessment	Compliant
Comments	BNM has a strong program for ensuring that effective governance, staffing, and processes are in place for the important control functions of a bank. BNM focuses heavily and effectively on offering director training programs.
Principle 18	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	<p>EC 1 Under the AML regime in Malaysia, the BNM is the only competent authority appointed by the MOF since 2002. Section 7 of the AMLTFA explains the functions of the competent authority and section 8 explains the powers of the competent authority in relation to receiving, analyzing and disseminating information received to law enforcement agencies. In addition, BNM has issued the AML/CFT Standard Guidelines (AML GP1) for all reporting institutions under the AMLTFA, supplemented by AML/CFT Sectoral Guidelines 1 specifically for Banking and Financial Institutions (AML GP1(1)), to ensure alignment with the FATF Recommendations.</p> <p>EC2 Section 19 (1) of the AMLTFA requires financial institutions to implement internal programs, policies, procedures and controls to detect suspected ML/TF activities. Section 19(2)(a) further requires the establishment of internal procedures in financial institutions to ensure high standards of integrity of their employees. In assessing the AML/CFT measures of the banking institutions, BNM supervisors review the relevant policies and procedures to ensure that they are aligned with the risk profile and business activities of the banking institutions and are in compliance with the AMLTFA, AML GP1 and AML GP1(1). The policies and procedures are required to be approved by the Board. Effective implementation of the policies and procedures are verified through on-site reviews.</p> <p>BNM also undertakes regular awareness, surveillance and enforcement activities to ensure that the policies developed and regulatory obligations are observed and adhered to by the financial sector, in order to prevent the banks from being abused for criminal activities. The framework that is in place encompasses implementation of a risk-based compliance framework, application of customer due diligence (CDD) measures,</p>

requirements for a database of “red flags” and electronic filing system for submission of cash transaction report (CTR) and suspicious transaction report (STR).

EC 3 The obligation on the banks to report CTRs and STRs to the competent authority is provided under section 14 of AMLTFA. Section 20 of AMLTFA overrides banking secrecy in so far as it relates to the mandatory performance of reporting obligations by the relevant financial and non-financial institutions on cash and suspicious transactions, as well as for the purpose of financial investigations. The submission of STRs by banks averages 52 percent of all submissions annually. As at 31 July 2011, the banking institutions contributed the second highest number of STRs which is 26.5 percent of total STRs received.

Banks are also required to report any incidences of fraud, including attempted fraud, against them even where no loss was incurred. The reporting by banks is done via the electronic Fraud Database (e-FIDS) (see also CP 15).

EC 4 Section 19(1) of AMLTFA requires the financial institutions to adopt, develop and implement internal programs, policies, procedures and controls to detect suspected ML/TF activities. Section 19(2)(b) of AMLTFA obliges banks to conduct on-going employee training programs, such as “know-your-customer” programs. Section 16 of AMLTFA requires reporting institutions to conduct CDD including to verify, by reliable means, among others, the identity, representative capacity, domicile, legal capacity, business purpose of any person as well as other information on that person. Under paragraph 5.3.3 of AML GP1, institutions are required to “know the beneficial owners and control structure of the corporate customers” and under paragraph 5.6, there is an obligation to undertake CDD on “any natural person who ultimately owns or controls the customer’s transaction if it suspects a transaction is conducted on behalf of a beneficial owner and not the customer who is conducting such transaction”.

In addition, paragraph 5.3.3 of AML GP1 requires the reporting institutions to know the control structure of corporate customers and to determine the source of funds. Paragraphs 5.9 and 5.10 of AML GP1 require the financial institutions to conduct enhanced CDD and obtain approval from the senior management of the institutions before establishing business relationships with higher risk customers. Paragraphs 4.1 and 4.2 of the AML GP1(1) provide the guidelines for banks to conduct their CDD.

Under the AML/CFT regime, section 17(1) of the AMLATFA requires the reporting institution to maintain any record for a period of not less than 6 years from the date an account has been closed or the transaction has been completed or terminated. Paragraph 6.1.1 of AML GP1 requires the reporting institution to keep the relevant records including any material business correspondences and documents relating to customers due diligence procedure, for at least 6 years after the transaction has been completed or after the business relations with the customer have ended.

AML/CFT measures are integrated into the banking institutions’ overall risk management control functions and are assessed as part of the BNM supervisors’ overall prudential assessment. BNM supervisors’ assessment includes among others:

- Board and senior management oversight, including on AML/CFT matters;
- Operational management such as self assessment on key control standards

	<p>which include controls for KYC;</p> <ul style="list-style-type: none"> • Compliance and risk management functions to mitigate ML/TF risks; and • Internal audit program and manual, including for AML/CFT and the quality of audit conducted. <p>EC 5 Paragraph 4.13 of GP1(1) requires banks to take the necessary measures to ensure that they are not exposed to the threat of money laundering and financing of terrorism through the accounts of the respondent institutions or being used by shell banks. When entering into correspondent banking relationships, the banks should capture and assess essential/key information on the respondent bank to determine the reputation and quality of supervision.</p> <p>EC 6 The assessment on AML/CFT measures is part of the BNM supervisor's assessment of a banking institution's significant activities, which are performed on a periodic basis depending on the materiality and issues of concern of particular significant activities. Thematic assessments have also been performed periodically (2006 and 2010). The 2010 thematic assessment raised a number of implementation issues and directives were issued to two banks. The FIU employs 25 AML/CFT specialists, 10 of which are involved in the analysis of reports, 8 of which are involved in policy and 7 deal with institutions that are not subject to other supervision.</p> <p>EC 7 Section 73 of BAFIA enables BNM to exercise intervention powers, which includes the power to issue directions and removal of directors from office in certain circumstances, including where BNM is satisfied that the bank has contravened a provision of the law. The Governor of BNM may, with the concurrence of the MOF, compound any person for breach of any provisions of BAFIA. A criminal prosecution may be instituted against any person with the approval of the Public Prosecutor.</p> <p>In 2011, BNM has issued directives to two licensed banks under section 22(3) of the AMLATFA for non-compliance with Part IV obligations. Another two licensed banks were compounded pursuant to section 92(1) of the AMLATFA for failure to comply with reporting obligations under Part IV.</p> <p>EC 8 Reporting institutions under AMLATFA are required to develop and implement a compliance program which is meant to guard against and detect any offence pursuant to section 19 of the Act. BNM supervisors also review banks' audit plan, audit scope and audit programs to assess whether the relevant areas are assessed. They also review the reports of the compliance officer. The BNM supervisors also review the screening process prior to the employment of staff.</p> <p>EC 9 The BNM supervisor determines that the banking institution has policies and processes for employees to report potential frauds or anything related to abuse of financial services. This includes:</p> <ul style="list-style-type: none"> • Assigning a dedicated officer/unit to whom the report could be made; • Mechanism to ensure the confidentiality of the employee making the report; • Processes to assess/verify the report; and • Escalation process to the appropriate senior authority within the banking
--	---

institution.

Para 7.2 of AML GP1 also states that banks should have in place adequate management information systems as a complement to the customer due diligence. This is to ensure that timely information is provided on a regular basis to enable banks to detect any suspicious activity.

EC 10 Section 24 of the AMLATFA provides protection against any civil, criminal or disciplinary proceedings on persons who disclose or supply any information in relation to a suspicious report under Part IV of the Act so long as the information was disclosed and supplied in good faith. The secrecy obligations or other restrictions on the disclosure of information are overridden by section 20 of the AMLATFA. The Whistleblowing Protection Act 2010 also aims to protect individuals who disclose information on corrupt practices or improper conduct in the private and public sector to any enforcement agency based on his belief that any person has, or is preparing to engage in improper conduct, provided that such disclosure is not specifically prohibited by any written law.

EC 11 Section 21(3) of the AMLATFA requires the supervisory authorities to report promptly to the FIU any information received from any reporting institution relating to transactions or activities that could be related to an unlawful activity or offence under the Act. As at 12 August 2011 (2008–2011), BNM has disclosed 4,821 STRs as financial intelligence to domestic law enforcement agencies and foreign enforcement agencies on a variety of offences.

EC 12 Cooperation arrangements are spelt out under section 40 of CBA, where the definition under section 2 of “supervisory authority” includes a foreign supervisory authority. However, the sharing of information and document is subject to an undertaking for protecting the confidentiality of such information and document and the purposes for which it shall be used. In addition, section 88 of CBA provides that BNM may in the exercise of its powers or the discharge of its duties or the performance of its functions, under CBA or any Act it enforces or any other written law, give information in relation to the commission of an offence under CBA or under the Act it enforces or any other written law, to the Police. BNM may also convey any or all information in relation to such offence to any financial institution or other person affected by such offence or to any authority or person having power to investigate under or enforce, the provision of the law under which the offence is suspected by BNM to have been committed. No information related to suspected or actual criminal activities has been shared so far between BNM and other foreign supervisory authorities as there has been no such request made thus far by foreign supervisory authorities.

At the domestic level, the National Co-ordination Committee to Counter Money Laundering (NCC) was established in April 2000 to enhance cooperation among 15 Ministries and government agencies involved in the fight against money laundering and terrorism financing. BNM, which is the NCC Secretariat, regularly updates members on the experiences of other countries in combating money laundering and terrorism financing, reviews existing investigative processes and fine-tunes the national anti-money laundering and counter financing of terrorism program. Each NCC member is responsible for research into matters relating to money laundering and terrorism financing, sharing of information, reporting on progress and implementation of NCC decisions within its jurisdiction.

	AC 1 Within BNM, the Special Investigations Unit (SIU) is tasked to investigate any criminal activities committed under the Acts administered by BNM, such as BAFIA, IA and CBA. If the criminal activity is listed as a serious offence under the Second Schedule of the AMLTFA, BNM being a law enforcement agency may also take action and exercise extensive investigation powers under the AMLATFA such as the freezing and seizing of property. There are currently 50 staff in the SIU.
Assessment	Compliant
Comments	The BNM has 25 specialists in AML/CFT issues, none of whom attends on site examinations. The assessors recommend AML/CTF Specialists join onsite BNM supervisors for the examination of higher risk banks.
Principle 19	Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups—and of the banking system as a whole—focusing on safety and soundness and the stability of the banking system.
Description	<p>EC 1: Using its SuRF framework, BNM supervisors identify significant activities carried out by the institution, the types and level of risks inherent in the activities, and the adequacy of mitigants put in place by the institution to manage the risks. Earnings and capital strength are then assessed to gauge their ability to provide the appropriate cushion for residual risks. SuRF is applied for the supervision of all financial institutions under BNM's purview, hence allowing similar risks to be assessed in a consistent manner across the set of supervised firms.</p> <p>A Relationship Manager (RM) is appointed for each banking institution and is responsible for performing continuous surveillance and supervisory activities over the institution. The RM is the focal point for supervision of the assigned institution and serves as the primary contact with the institutions. In discharging this responsibility, RMs are assisted by the Special Risk Units (SRUs) which provide support and guidance on technical and complex risk areas, typically by offering guidance to the supervisors rather than interacting directly with the banks.</p> <p>BNM supervisors develop supervisory plan for the institution, which includes on-going monitoring and on-site review. The assessors' review of various supervisory plans indicates they provide a good mix of actions to be taken, reflecting the range of risks faced by banking institutions.</p> <p>EC 2: Financial stability monitoring and risk analysis are undertaken at the micro and macro levels. The macro-prudential assessment, as performed by the Financial Surveillance Department, and horizontal risk assessments by the respective SRUs, are fed into the micro-surveillance analysis to help in the assessment of the financial position of individual banking institutions as well as in gauging implications on the institutions' operations. From discussions with BNM and bankers, and document review, the assessors found that the scope of the horizontal assessments includes a number developments in industry practices, e.g., loan restructurings and pricing of financial instruments, whose results were useful for the supervisors and the bankers.</p> <p>Regular discussions are held between micro and macro surveillance functions of BNM to facilitate the gathering of information, identification of issues and risks, and formulation of</p>

policy responses to mitigate the risks.

BNM interacts with the SKM that regulates the cooperatives industry although no MOU is in place. BNM does have an MOU with the SC which regulates the stock broking, asset management and trust industries; the limitations of the MOU are discussed in CP 1.6 and CP 24. BNM also collaborates closely with PIDM in the areas of surveillance of member institutions which is guided by the recently amended SAA; the nature of the interaction with PIDM in dealing with problem situations is discussed in CP 23.

EC 3: BNM adopts a risk-based approach in its assessment of institutional safety and soundness, as reflected in its SuRF framework, which draws supervisory attention to areas or activities of higher risk. This comprehensive standard framework enables BNM to have:

- A consistent methodology for assessing and assigning ratings across different financial institutions with a well-structured risk assessment process through separate assessment of inherent risks and risk management functions;
- A means for quantitative and qualitative comparisons between supervisory assessments of peer institutions to ensure appropriateness and reasonableness of assessments. The comparison takes into account supervisory expectations set through guidelines issued by BNM, institution-specific risk exposures and management practices and assessment of other banking institutions with a similar risk profile.

The framework is applied on consolidated basis for the assessment of all material activities/entities within a banking group (subsidiaries & branches) both in Malaysia and cross border; its application to FHCs is, as discussed in CP 24, not fully applied on a consolidated basis. The risk assessment is updated on a regular basis based on the ongoing monitoring and on-site review results. That risk assessment and the placement of institutions into specific Intervention categories under the Supervisory Intervention Guide (SIG) are at the core of the BNM supervisory regime. There are six supervisory steps which drive the development of those two products:

1. Preparing a Knowledge of Business (KoB) analysis to understand the institution's activities and operations, including its business objectives, strategy, key risk drivers including exposure to external developments, and Significant Activities (SAs);
2. Developing annual supervisory plans, using the results of the KoB analysis to prioritize supervisory work/resources toward institutions and areas of higher risk;
3. Monitoring the risk profile of banking institutions and developments that may affect the risk profile through off-site and on-site review;
4. Performing a risk assessment on the SAs identified (which include any line of business, business unit, subsidiary or enterprise-wide process which poses a significant potential impact to the institution's earnings and capital, or to achieving the bank's business objectives), and preparing a Risk Assessment Summary (RAS) and assigning a CRR. Seven risk categories are assessed under SuRF: credit risk, market risk, liquidity risk, operational risk, legal & regulatory risk, strategic risk and insurance risk --- each covers operational, governance, and risk control issues;

5. Preparing a supervisory letter to highlight issues and requirements/recommendations to the banking institution. All institutions are assigned an intervention stage rating which is linked to their respective CRR as well as their responsiveness to supervisory requirements and recommendations. The nature and intensity of supervisory intervention actions will be tied to those ratings. Supervisory letters are addressed to the Chairman of the institution's Board and copied to the Chief Executive Officer of the institution, PIDM, SC and other relevant parties. In addition, results of supervisory activities are also communicated to banking institutions via bilateral engagements between BNM supervisors and the institutions' Board and senior management; and
6. Following-up on the actions or measures prescribed on banking institutions. BNM supervisors track the issues and prescribed remedial measures on a regular basis and report status and progress in the monthly progress reports, RAS and 'Follow-up' review notes. BNM supervisors ensure that the institutions' responses and actions are timely, effective and satisfactory. The intensity of supervisory oversight and severity of supervisory actions increases when an institution fails to implement appropriate and effective remedial and corrective actions.

EC 4: BNM supervisors assess banking institutions' compliance with laws and prudential requirements through on-going monitoring and on-site reviews. Further, banking institutions and their external auditors in practice timely inform BNM supervisors of any breach of laws/regulations as provided by the laws, prudential requirements and explicit supervisory expectations. External auditors of banking institutions are required by law to inform BNM of any non-compliance with laws and regulations by the institutions (BAFIA Section 40 (15))—discussions held with an external auditor confirmed full awareness of this responsibility; however, the banking institutions are themselves not adhering to a specific provision of law but to supervisory expectations that they inform the BNM of such developments.

EC 5: Many types of structural change require prior BNM approval/notice under BAFIA:

- Section 29—Consent for establishing or acquiring any subsidiary;
- Section 30—Consent for opening any offices of licensed institutions;
- Section 49—Approval for change in the control of a licensed institution or its holding company, for the sale, disposal or transfer of business, or for amalgamation/merger or the reconstruction of the licensed institution;
- Section 51—Reporting any agreement/arrangement for the acquisition or disposal of more than 5 percent of the institution's shares;
- Sections 55(1) , 57(2) – Consent for appointment of directors and CEO;
- Section 72—Advice of inability to meet any of its obligations; and
- Section 40(15)—Requires the external auditor to report immediately matters that posed threat to the safety of the institution, such as contravention of BAFI, fraud, irregularity and inability to maintain minimum capital funds.

Others are required by specific regulatory provisions, such as :

- Section 2.28 (GP1)—Required resignation and removal of independent

	<p>directors from the Board can only take effect until cleared with BNM;</p> <ul style="list-style-type: none"> • Section 2.41(GP1)—Approval required for appointment of Chairman of the Board; • Section 2.44 (GP1)—In the absence of its CEO, a licensed institution is required to inform the BNM of the person who will be directly responsible for the overall running of the licensed institution. <p>In addition to the above requirements, banking institutions are also expected to inform BNM supervisors of any material change in their business operations and/or any adverse development in their risk position. As noted above, banking institutions are expected to immediately notify BNM supervisors of any breach of legal and prudential requirements. These reflect supervisory expectations that are enforced by BNM supervisors in the course of the on- going supervisory monitoring and surveillance.</p> <p>EC 6: BNM has numerous information systems in place, both internal and external to support its micro and macro surveillance functions. (Refer to CP 21 for details on the means used by BNM supervisors to collect, review and analyze prudential reports and statistical returns.) In addition to its extensive internal information systems, BNM also subscribes to external information databases such as Bloomberg and Moody’s Credit Edge.</p> <p>AC 1: The SuRF provides for a comprehensive and forward-looking assessment of a banking institution’s risk profile and direction of the risk. The direction of risk is assessed based on the assessment of the potential changes in business and economic climate, and the business focus and risk management strategy.</p> <p>Scenario-based stress tests on credit, market and liquidity risks are conducted at both the macro and micro level to provide a forward-looking assessment of the capacity of banking institutions to withstand potential significant adverse macro-financial shocks, as well as the resulting implications to their earnings and capital.</p>
Assessment	Compliant
Comments	<p>BNM has a well developed framework of supervision with a strong mechanism to ensure effective and consistent analysis of risks, with access to a variety of information sources to keep its assessments current. We have several recommendations for improvement:</p> <ul style="list-style-type: none"> • Increase the number and experience level of risk specialists and provide for their spending more time in the field; and • Revisit its methodology for assigning ratings to banks to provide capacity to factor in more explicitly adverse effects from affiliates.
Principle 20	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	<p>EC 1: The supervisory assessment of banking institutions entails a process of on-site reviews and off-site surveillance. The RM, in consultation with the Director, decides on the mix of the appropriate on-site and off-site supervision, based on the CRR and Intervention category, emerging macro concerns, new business activities, and significant developments (i.e., merger, change of management and new regulations). The frequency of on-site reviews and depth of off-site surveillance are determined by the risk profile, adequacy of risk control functions, strength of</p>

management and Board, complexity of the issues highlighted, ratings and size of the banking institution. For complex or technical issues, BNM supervisors will seek the assistance of the (limited) number of risk specialists.

EC 2: The RM is responsible for both on-site and off-site surveillance, ensuring effective coordination. On-site and off-site supervisory strategies are developed on an annual basis based on the risk profile of a banking institution. BNM supervisors are required to present the outcome of the supervisory assessment and CRR of a banking institution to a rating panel for internal review by independent peers within the Department:

- This process of challenging the outcome of the supervisory process acts as a check on whether the planning and execution of on-site and off-site activities have been effective and consistent;
- The review process also provides a quality check and consistency on the assessment of the CRR, areas of supervisory concerns and supervisory intervention actions of the banking institution as it allows the panel members to challenge the CRR accorded to the banking institution;
- Any intended changes in CRR (up or down) will require BNM supervisors to present their assessment to a second panel which is as a minimum, chaired by the Assistant Governor of the Supervision Sector.

EC 3: During on-site reviews, BNM supervisors perform the following:

- Observe corporate governance practices including confirming the state of compliance with approved policies and procedures;
- Review minutes of meetings of the Board, Board committees, management committees and the inspection of relevant books and records;
- Conduct walk-through tests on identified areas of the business operations, processes or systems;
- Validate/determine the veracity of financial information in the periodic statistical submissions by the banking institution to BNM, through the FISS and other reports. For example, BNM supervisors validate the accuracy of the outstanding balances of impaired loans and the collateral values to determine the adequacy of loan impairment allowances made (reported monthly);
- Engage with model developers and users to validate the reliability of models used by the banking institution for capital or other purposes (confirmed by the assessors in discussions with bankers); and
- Seek further clarification/explanation on issues in discussions with Board members, senior management, and selected staff.

EC4: The off-site surveillance involves monitoring of the financial performance and condition of a banking institution through regular reviews of its financial data and information submitted to BNM under regulatory requirements or as specifically requested. The analysis performed by BNM supervisors is focused on material risks and financial strength of the banking institution and typically includes capital adequacy, earnings performance, asset quality and liquidity risk. It

involves:

- Reviewing regulatory reports;
- Requesting submission of supporting information and documents that provide greater details on exposures and financial aspects, such as monthly management accounts, risk management reports and schedules on large borrowers/depositors;
- Reviewing information which is publicly available such as the rating reports by the rating agencies and information from other regulatory authorities;
- Engaging with the Board, senior management and staff who are principally responsible for internal audit, risk management, compliance and management information support;
- Analyzing the submissions and supporting reports to identify salient problem areas in operations and compliance with prudential requirements such as capital adequacy and single customer limits;
- Performing scenario-based stress tests on the banking institution's credit, market and liquidity positions and identifying areas of vulnerability;
- Integrating macro surveillance's assessment with micro surveillance results to ensure completeness and robustness of the assessment/rating of the banking institution.

BNM also monitors the progress of remedial actions. Reports are typically requested to be submitted within six weeks from the date of the supervisory letter (confirmed by the assessors through the review of such letters). Where supervisory concerns remain unresolved, the banking institution is required to continue to make submissions on the status of corrective actions on a quarterly basis. The off-site assessment on the adequacy and effectiveness of rectification measures by banking institutions also serve as a basis for further work/follow-up actions. Off-site surveillance also provides inputs and updates for the RAS and Review Notes. The identification of potential financial distress and follow-up on supervisory concerns is expected to be more efficient with enhanced IT infrastructure with the implementation of the Micro Surveillance System in 2012.

EC 5: The RM and team of supervisors are the focal point of contact with the banking institution, maintaining regular on-going communications throughout the supervisory process (i.e., analysis, planning, execution, reporting and follow-up). The communication between the banking institution and BNM supervisors is conducted either on a routine basis or triggered by certain events that may alter or impact the risk profile of the institution.

During the on-site reviews (including thematic reviews), BNM supervisors meet with the banking institution's senior and middle management including the CEO, heads of departments/business units (including the CRO, CIA, COO, Financial Controller, Head of Compliance, and heads of business units) to discuss any supervisory concerns, emerging risk issues, business strategies, risk management problems, and challenges faced in achieving its business objectives. These meetings also serve as a forum for BNM supervisors to convey recommendations for

corrective actions, seek feedback from management, and follow up on progress in addressing supervisory concerns. At the conclusion of each on-site review, BNM conducts an exit meeting to discuss with management supervisory concerns and obtain a commitment to rectify weaknesses; and if necessary, engage with Board members to discuss supervisory concerns and remedial actions.

EC 6: In considering the quality of the Board (including Board Committees) and management, BNM supervisors are guided by SuRF which provides the assessment framework and criteria in determining the overall rating of either 'Strong', 'Acceptable', 'Marginal' or 'Weak' for the assessment of the Board and senior management, and by:

- Sections 55, 56 and 57 of BAFIA on the appointment of a director, disqualification of a director/officer and appointment of a CEO;
- Guidelines on Corporate Governance for Licensed Institutions (BMN/GP1)
- Guidelines on Fit and Proper for Key Responsible Persons.

BNM supervisors request and review records such as the terms of reference, agenda and minutes of meetings of the Board and Board committees, and engage with Board members. In considering the quality of the Board, BNM supervisors will:

- Assess the effectiveness of the Board's structure encompassing its composition as well as roles and responsibilities, both collectively and individually;
- Assess robustness of the selection and appointment processes of the directors, the appropriate mix/adequacy of the Board skills, qualifications and training;
- Consider how actively the Board and Board Committees carry out their responsibilities, including the depth of deliberations by the directors in providing objective insights and guidance to management; and
- Assess the Board and Board Committees' effectiveness in providing oversight over management and operations to ensure that the risks to the banking institution are appropriately mitigated and business objectives, strategies, plans, policies and practices are appropriate and are executed effectively.

BNM looks for balance in the composition of the Board and the effectiveness of individual members. In as much as directors typically have no more than a three-year term, BNM prepares itself for the re-appointment process. BNM supervisors described to the assessors how they factor in specific Board minute review for individual directors, supplemented by direct meetings with them, to inform their decisions.

In considering the quality of management, BNM supervisors:

- Assess the capability of management, individually and collectively (skills, competence, experience, character, knowledge and leadership qualities);

- Assess the effectiveness of management in executing the approved strategies and business plans, while maintaining an appropriate governance and control culture.

BNM focuses on determining if the senior management team has the requisite skills, experience, core competencies and integrity to carry out the business of the banking institution, given its risk profile. It specifically assesses the suitability of a candidate for CEO, guided by the “Guidelines on Fit and Proper for Key Responsible Persons”—those guidelines require vetting the proposed candidate’s academic background and work experience to ensure that he/she possesses the relevant qualifications, skills and experience, and assessing the candidate’s ability to understand and manage the banking institution’s activities and related risks.

EC 7: Under the SuRF framework and methodology, the assessment of internal audit is done as part of the assessment of the risk management control functions of the banking institution. The assessment is done on a horizontal basis for each significant activity (Track 1 assessment) and complemented by a vertical analysis for the overall analysis of the internal audit function (Track 2 assessment).

In assessing the quality of the internal audit function during either on-site reviews or off-site surveillance, BNM supervisors will:

- Examine policies and procedures governing the overall audit process;
- Determine whether the internal auditors have a written mandate to carry out responsibilities independently;
- Ascertain if the audit methodology and audit practices adopted by the internal auditor conform to accepted practices and applicable laws and are credible and reliable to provide independent assurance to Board and senior management.
- Assess if the CIA has the necessary skills and experience to lead the function;
- Assess if the internal audit outfit is adequately and suitably staffed with competent auditors and the internal audit infrastructure commensurate with the level of inherent risks of the banking institution;
- Review the performance of internal audit in achieving the audit plan and in particular, in covering the significant activities of the banking institution and incorporating the areas highlighted in the BNM’s supervisory letter and assess if the internal auditors have the capabilities to respond/review the audit cycle should changes occur in the risk profile;
- Review internal audit reports (including investigation reports, subsidiaries and cross border operations). Discussions with Internal Audit personnel confirmed that such reports are shared and discussed with BNM supervisors.

EC 8: The results of on-site reviews and off-site surveillance, including areas of supervisory concern, and supervisory requirements to rectify those concerns, are communicated to management and the Board. The communications include:

	<ul style="list-style-type: none"> • Conducting a formal exit discussion with the senior management to share findings, supervisory concerns, if any, and recommendations for corrective actions. The feedback and comments from this meeting are taken into consideration by BNM supervisors in finalizing supervisory products; • The Director or the Deputy Director of the supervision departments will chair a session with the senior management and the Board members of the banking institution to inform them of the CRR and supervisory concerns and recommendations for corrective actions. If necessary, and where there are serious issues of supervisory concern or where the banking institution is large and of significant risk, these communication sessions can be chaired by the Assistant Governor or the Deputy Governor; • Issuance of a supervisory letter addressed to the Chairman, and copied to the CEO and Chairman of the BAC, detailing the CRR, supervisory concerns and recommendations for corrective actions; and • Follow up letters addressed to the Chairman and CEO on inadequacies in the corrective actions or failure to meet timelines to resolve supervisory concerns, after BNM supervisors had reviewed and assessed the corrective actions taken or to be taken. <p>AC 1: The results of on-going on-site reviews and off-site surveillance are discussed with management and the Board (refer to EC 8). Bilateral or tripartite meetings with the external auditors of the banking institutions are held at least annually to discuss audit findings and financial accounts (confirmed in assessor discussions with external auditors). Where necessary, BNM supervisors engage with the Chairman of the BAC to address the issues raised by the external auditors. Similarly, the senior management and Board members of the banking institution are expected to inform BNM supervisors on a timely basis, of any emerging issues, unanticipated losses, and events that would affect the financial performance/condition of the banking institution.</p> <p>When necessary, BNM supervisors have separate meetings with independent directors to seek insights into the roles played by the Board and its committees as well as to facilitate BNM supervisors in assessing the effectiveness of the Board and the Board committees. BNM supervisors also hold separate discussions with Board Committees (i.e., Audit, Nomination, Remuneration and Risk Management committees) in circumstances where BNM supervisors have reservations over the effective functioning of the Board, particularly when certain directors may have dominated the Board, and/or when specific concerns exist on areas such as adequacy of risk management and internal audit, compliance with rules and regulations, challenges and emerging risks facing banking organizations.</p>
Assessment	Compliant
Comments	BNM has a strong and well structured supervisory program, using appropriate supervisory techniques.
Principle 21	Supervisory reporting. Supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis and a means of independent verification of these reports, through either on-site examinations or the use of external experts.

Description	<p>EC 1 Section 43 of BAFIA empowers the BNM to request prudential returns from banks on a solo and consolidated basis. The BNM uses an online reporting system FISS (Financial Institutions Statistical System). FISS comprises banking statistics in terms of income, expenses, assets, liabilities as well as contingent liabilities. The FISS system comprises automatic checks on the accuracy and comprehensiveness of data. Since the submission of the prudential returns went online, the physical sign off of the accuracy and comprehensiveness of the prudential returns was abolished.</p> <p>EC 2 Various sections of BAFIA provide legal powers to BNM to require banks to submit information.</p> <p>Section 41: Financial statements to be submitted to Bank Section 43: Statistics and information to be submitted Section 69: Examination of licensed institutions Section 70: Power to direct investigation Section 71: Production of licensed institution's books Section 79: Extension of power to related company Section 98: Disclosure for facilitating performance of functions by Bank Section 99: Other permitted disclosures Section 113: Submission to Bank of information required by it Section 126: Power to issue guidelines, etc</p> <p>The reports submitted by the banks are on a stand alone as well as a consolidated basis and contain information on such matters as on and off balance sheet exposures, profit and loss, capital adequacy, liquidity, large exposures, assets concentration, (by economic sector , geography and currency) asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk. BNM also obtains information from the banks' financial holding companies as well as subsidiaries and other related companies. The legal power supporting this is stipulated in section 79 of BAFIA and Section 113.</p> <p>EC 2 BNM has issued GP8/GP8i—Guidelines on Financial Reporting, requiring banks to submit their financial statements on a quarterly basis, prepared in accordance with the financial reporting standards approved by the Malaysian Accounting Standards Board (MASB), which is fully in compliance with IFRS. The primary objective of the guidelines is to ensure consistency in disclosure by specifying the minimum reporting format to be observed by the banks.</p> <p>EC 3BNM GP8/GP8i—Guidelines on Financial Reporting requires banks to ensure that financial statements are prepared in accordance with valuation principles authorized under the FRSS issued by MASB which also includes the specific requirements on the use of Fair Value Option. In view of this, the banks are required to comply with the valuation rules specified under the relevant FRSSs, such as FRS139 for financial instruments and FRS140 for investment properties. The requirement to comply with the valuation rules prescribed under the relevant FRSSs promotes a standard and consistent practice across the industry.</p> <p>EC 4 As explained in CP 19, the assessment on the banks' overall risk profile, determines the CRR, which is then mapped to the supervisory intervention stage. The supervisory intervention stage is used to determine the appropriate oversight level and the frequency or intensity of supervisory monitoring actions to be conducted on the banks that reflect a specific risk profile. The intensity of supervisory oversight and</p>
-------------	---

severity of supervisory actions are consistent amongst the banks within each stage and is proportionately intense and severe across inferior stages. This level of supervisory oversight determines the frequency of data collection and analysis to be conducted on each individual bank. Other factors that determine the level of frequency of the data collection and analysis include triggers arising from specific events or developments. For example, in cases of fraud being reported or sudden expansion of a particular business activity by a bank, more frequent reporting is required.

EC 5 The availability of the „FISS“ data allows BNM supervisor to consolidate the entire industry’s data across the time series (flow data) and data on all banks at the same reference date (stock data) for comparison purposes. Access to FISS has also evolved into a more user-friendly system called Banking Financial Analysis System (BFAS) whereby it can be linked to an excel worksheet for further detailed analysis. Further comparison is also conducted which amongst others includes conducting comparative analysis on the banking industry’s top 10 depositors for all types of banks on a quarterly basis. The purpose of this analysis is to assist the BNM supervisor in identifying the level of concentration risk, sources of risk and major liquidity providers in the banking system. Comparison is also made on the stress test analysis on a quarterly basis, to highlight sources of vulnerabilities and identify scenarios that may require supervisory action for a particular bank. In addition, comparison is also carried-out on the credit portfolio particularly for the top 20 loans and Private Debt Securities (PDS) exposures. This comparative analysis provides information on the total large exposures in the banking system as well as banks and borrowers that contribute to the large exposures.

EC 6 As stated in EC 2 above, Section 113 of BAFIA requires any licensed or any scheduled institution or any foreign institution or any person engaged in the provision of finance or any corporation related to the aforesaid institution or aforesaid person to submit any information relating to their affairs or business to BNM when directed to do so for the purpose of the exercising of any of BNM’s powers, the performance of any of BNM’s functions or the discharge of any of BNM’s duties, under this Act or under any other written law.

In addition, section 71 of BAFIA allows the BNM to exercise power to request and make an examination of the documents or other information of any banks if the need arises. This section is read together with section 79 which empowers BNM to extend reporting requirement to related corporations of licensed institution and to director-controlled institutions. The BNM currently receives consolidated financial information including the financial holding company for the six domestic banking groups headed by a financial holding company.

EC 7 The power to access banks’ records and documents for the furtherance of supervisory work is provided under section 71 of BAFIA on production of banks’ books and documents, whereby the directors and officers of the banks under examination shall afford the BNM supervisor access to all their books or other documents and should produce all the information as the BNM supervisor may require. The BNM supervisor also continuously engages with Board members, senior management and other relevant personnel as this is provided for under section 71(3) of BAFIA on production of bank’s books and documents, where no directors or officers shall fail to give information as required by the BNM supervisor. In addition, the BNM supervisor’s access to the bank’s Board, management and staff also encompasses performing reviews on the various Board and management committees’ minutes as well as other relevant documents such

as policies, strategy and operational procedural manuals.

EC 8 BNM has various ways to ensure that information submitted is accurate and timely at all times. One of the methods is through exercising the provisions under BAFIA, where BNM is empowered under section 2(4)(a) to require any person to submit information on a timely basis, while section 2(4)(b) prohibits submission of false or misleading information. Any breach of these sections could result in imposition of general penalty under section 104 and in the case of continuing offence, shall in addition be liable to be punished with a daily fine, for every day during which the offence continues.

To further ensure the accuracy of the information submitted, the FISS system which is maintained by the Statistical Services Department is structured with an in-built mechanism that provides for logic checks to be conducted to detect any outliers in the movement of data on a monthly basis. The respective BNM supervisor will be alerted by the Statistical Services Department on any movement that exceeds the variance threshold set, which is reviewed on a timely basis for further actions as appropriate. The banks are also required to analyze the variances indicated by the system to ensure consistency and credibility of the data submitted to BNM. This mechanism allows for detection of any misreporting and inaccurate submission of information by the banks.

EC 9 The BNM meets this EC by three processes: the ongoing assessment of bank's communication and information, the validation process via approval of financial statements and thematic reviews.

The first process is the assessment, guided by BNM's SuRF which considers the effectiveness with which the banks' information and communication function provides timely, accurate and insightful information, which supports effective decision-making, to their Board and senior management. For the purpose of this assessment, BNM supervisor performs a review of the overall data governance structure of the banks to determine the effectiveness of the control environment in ensuring data quality. The governance structure should be subjected to a periodic review by senior management and independent review by internal audit or an external party.

For the approval of the banks' financial statements on a quarterly, half-yearly and annual basis, banks are required to provide supporting documents for the BNM supervisor to validate the detailed breakdown of the key components of the financial statements. Significant changes are scrutinized and need to be justified. If necessary, the BNM supervisor conducts on-site validations, particularly to determine the adequacy of the impairment provisions made by the banks which includes among others the review on bank's impairment methodology. External auditors confirmed that the supporting documents submitted to the BNM include a line by line reconciliation of the annual accounts with the prudential returns.

From time to time, BNM also undertakes thematic reviews which are conducted upon the implementation of new prudential standards, which require submission of reports. This enables the BNM supervisor to review the overall governance process prior to the submission for the newly introduced prudential standards, thus enabling the banks to obtain the right understanding of BNM's requirements as well as promote consistency in information reported across the industry.

EC 10 BNM generally does not utilize external experts to perform supervisory tasks as

	<p>BNM has a dedicated team to carry out the supervisory functions. However, if the need arises, the BNM supervisor is still empowered to appoint external experts under the provision of section 3(3) of BAFIA, to assist BNM with the supervisory task. To complement BNM's supervisory task, the BNM supervisor does, to a certain extent, leverage on work done by the banks' external auditors particularly in the verification of financial statements. This is also provided under section 40 of BAFIA on Appointment and Duties of Auditor whereby BNM may at any time require the external auditors to submit reports or additional information, enlarge the scope of an audit, and carry out specific examinations as determined by the BNM supervisor. In most cases, input from external auditors will be used for supervisory assessments to minimize duplication of efforts. The BNM organizes periodic sessions with external auditors to clarify supervisory expectations and align supervisory procedures. (see also CP 22)</p> <p>EC 11Section 40(15) of BAFIA requires external auditors to alert BNM on any material short comings identified during the course of their audit work. Nevertheless, in the event where an external expert is appointed, such requirement will have to be incorporated in the terms and conditions at the initial stage of appointment of such experts.</p>
Assessment	Compliant
Comments	<p>The assessors recommend BNM require at least annual physical sign off of the prudential returns by the Senior Management of the bank. The BNM states that it is currently enhancing its on-line statistical reporting (i.e. the Integrated Statistical System(ISS) Project) to incorporate a digital signatory requirement by senior management for each submission by the banks.</p> <p>While the assessors commend the BNM for the legal provisions with regard to the power of the BNM to require adjustments to the financial statements and to obtain supporting evidence, they recommend BNM discontinue the use of Section 41 (4) of Bafia. This specific article requires the BNM to inform the banking institution in writing that the financial statements and supporting documents are satisfactory in terms of form and content. This requirement somehow interferes with the independence and responsibility of the external auditor and unduly exposes the BNM to reputational risk. Moving forward, the provision under Section 41 of BAFIA is proposed to be removed in the FSA as currently drafted.</p>
Principle 22	<p>Accounting and Disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.</p>
Description	<p>EC1 & EC2 The financial reporting framework for all companies (including banking institutions) in Malaysia is governed under Financial Reporting Act 1997 (FRA) and Companies Act 1965 (CA). Banking institutions are required to ensure that the disclosures in their financial statement are made in accordance with the financial reporting standards (FRSs) and BNM guidelines.</p> <p>Paragraph 2.97 of the Guidelines on Corporate Governance for Licensed institutions require the Board to establish an audit committee, whose responsibilities include ensuring fair and transparent reporting and prompt publication of the financial accounts. In addition, paragraph 5.2. of the Guidelines on financial reporting for banking institutions</p>

and Circular on the application of IFRS state that the Board is responsible to ensure that financial statements are drawn up so as to give a true and fair view of the state of affairs and the results of the banking institution. The guidelines further require the Board to have in place a sound financial reporting structure to ensure the integrity and credibility of financial statements.

As part of the supervisory process, BNM supervisors perform a walkthrough of the reporting systems used by the banking institutions' business divisions to ascertain the adequacy of internal controls e.g., usage and classification of data capture, control of suspense accounts and accounting reconciliations. BNM supervisors also review the consistency of data reported in the Financial Institutions Statistical System (FISS) with reports generated by the banking institution's core banking system and the financial statements. BNM supervisors may exercise its enforcement power pursuant to section 73 of BAFIA. In addition, banking institutions are required to reconcile any differences between FISS and the financial statements during the half year and year-end review of the financial statements.

EC 3 The valuation rules adopted by banking institutions are consistent with the principles prescribed under the IFRS. This may be supplemented by more specific application guidance set out by BNM where appropriate to promote consistency and ensure valuations are realistic and sufficiently prudent. In addition, paragraph 7 of the Guidelines on Financial Reporting for Banking Institutions and Circular on the Application of FRS and Revised Financial Reporting Requirements for Islamic Banks set out the supervisory expectations on expected controls (e.g., sound governance structure, risk management systems and related risk management policies and procedures) that should be put in place by banking institutions for the application of the fair value option for financial assets under FRS 139.

EC 4 Section 40(13)(b) of BAFIA empowers BNM to require the external auditor to enlarge or extend the scope of his audit while section 40(13)(c) of BAFIA empowers BNM to require the external auditor to carry out any specific examination or establish any procedures as BNM may specify. The BNM has used these powers frequently and provided some real life examples to the assessors. Paragraphs 5.4 to 5.6 of the guidelines on Appointment of External Auditors for Banking Institutions require that the audit scope should, at a minimum, include specific procedures to test the banking institution's internal controls over financial reporting in relation to the loan and investment portfolios.

Effective 1 January 2010, Malaysian Approved Standards on Auditing are in compliance with the auditing and ethical standards issued by the International Federation of Accountants. An arrangement is also in place for the Audit Oversight Board to inform BNM on the results of its inspections on audit firms which perform audits of banking institutions with respect to the degree of compliance with auditing and ethical standards.

EC 5 Paragraphs 5.4 to 5.6 of the Guidelines on Appointment of External Auditors for Banking Institutions state that the scope of the audit engagement shall have regard to the banking institution's financial reporting risk areas, and the audit program and audit plan must at least include specific procedures to test the banking institution's internal controls over financial reporting in relation to the loan and investment portfolio. In addition, the audit scope and plan should address any other areas identified by the board which present a significant financial reporting risk to the

banking institution.

EC 6 Section 40(1) of BAFIA requires banking institutions to obtain BNM's prior approval on an annual basis before an external auditor is appointed. Section 40(4) of BAFIA and paragraph 4.2 of the Guidelines on Appointment of External Auditors for Banking Institutions further set out the criteria that must be met by the external auditors both prior to and during the entire audit engagement.

In assessing the application for appointment (or reappointment) of external auditor, factors taken into consideration by BNM include:

- Quality of the past audit and performance as auditor of the banking institution;
- Feedback on the quality of past audit and the performance of the auditor from BNM supervisors of other financial institutions who have engaged the same engagement partner;
- Provision of non-audit services by the audit firm (i.e. materiality of the non audit services);
- Where the appointment (or reappointment) of external auditor is for investment banks, the views of the Securities Commission will also be obtained; and
- Results from assessment by the Audit Oversight Board on audit firms with respect to the degree of compliance with auditing and ethical standards.

BNM may reject the appointment (or reappointment) of an external auditor if concerns arise as a result of the assessment of the factors above. Appointments of auditors are for one year.

EC 7 Section 41(1) of BAFIA requires banking institutions to submit to BNM the audited financial statements and the auditor's report within 3 months after the close of each financial year. Unless notified by BNM in writing, banking institutions shall not publish the audited financial statements at the annual general meeting. The MASB announced the implementation of full convergence between the FRS and IFS on 1 January 2012. The International Standards on Auditing (ISA) have also been adopted in full and became effective for periods beginning on or after January 1, 2010.

EC 8 Section 42 of BAFIA requires banking institutions to publish a complete set of the annual financial statements within 14 days after the presentation of the financial statements at the general meeting, in at least two local daily newspapers. For interim financial reports, banking institutions are required to disclose the financial reports on their website not later than 8 weeks after the close of the interim reporting period. In addition, the Bursa Malaysia Securities Berhad's (Bursa) listing rules require all listed entities to announce their interim quarterly financial results within 2 months after the end of each quarter of a financial year and within 4 months from the close of the financial year for annual audited financial statements.

For Pillar 3 disclosure requirements on risk management practices and capital adequacy, banking institutions are further required to make additional disclosure of their risk management policies and capital adequacy as part of the Pillar 3 disclosure requirements on their website. Banking institutions are also required to disclose the minimum components of the corporate governance disclosures as part of the annual

report (paragraph 2.108 of the Guidelines on Corporate governance for licensed institutions).

EC 9 The IFRS and BNM disclosure requirements (“Guidelines on financial reporting for banking institutions”) include both qualitative and quantitative disclosures. They include:

- Information on a bank’s financial performance and financial position— paragraphs 54, 82 and 112 of FRS 101 Presentation of Financial Statements;
- Information on risk management strategies and practices, and risk exposures— paragraphs 33 to 42 of the FRS 7 Financial Instruments: Disclosures and Pillar 3 disclosure requirements;
- Information on transactions with related parties—paragraphs 13, 17, 18 and 19 of the FRS 124 Related Party Disclosures;
- Information on accounting policies—paragraphs 114 of FRS 101 Presentation of Financial Statements;
- Information on basic business—paragraph 26 of the IFRS Practice Statement Management Commentary;
- Information on management and governance—paragraph 2.108 of the Guidelines on Corporate Governance for Licensed Institutions; and
- Scope, content, level of disaggregation and detail should be aligned with the size and complexity of a bank’s operations—paragraph 8.3 of the Guidelines on Financial Reporting for Banking Institutions and paragraphs 24 to 46 of the Framework for the Preparation and Presentation of Financial Statements.

EC 10 BNM places responsibility on the Audit Committee of banking institutions to ensure that disclosure of information in the financial statements comply with the requirements under the FRSs and BNM guidelines. BNM supervisors review the Audit Committee’s minutes to assess the manner in which the Audit Committee discharges its function. Where accounting and audit issues were raised by the external auditors, BNM supervisors will monitor the progress and remedial actions taken by the banking institutions to address these issues. Where shortcomings are observed, a supervisory letter would be issued to the banking institution to address the concerns.

In addition, BNM supervisors engage with Audit Committee members periodically to determine the nature and extent of discussions between Audit Committee, external auditors and management, and the challenging/querying by the Audit Committee on financial reporting matters during Audit Committee meetings. In line with their statutory obligations, external auditors are required to ensure compliance with the disclosure requirements of both FRSs and BNM guidelines in relation to financial reporting before they can issue their opinion on the financial statements. BNM supervisors maintain ongoing engagements with external auditors as part of the process to confirm that banking institutions adhere to the reporting requirements under FRSs and BNM guidelines.

EC 11 BNM publishes the following publications on a regular schedule:

- Monthly and quarterly statistical reports that contain information on monetary and banking developments, economic reviews, as well as various other

statistical data (e.g., statement of assets and liabilities, information on loans); and

- Financial Stability and Payment Systems Report on annual basis which provides a detailed assessment by BNM of key risks in the Malaysian financial system and the capacity of the system to sustain its financial intermediation role in the economy. Key financial statistics (e.g., sources and uses of funds, capital ratios, income and expenditure) are provided as the annexure in the report.

These publications are available on BNM's website.

AC 1 Bilateral meetings with external auditors are held to discuss among others, accounting and audit matters, audit methodology (include sampling) used by external auditor, implementation issues arising from new FRSs and operational issues encountered during the financial year.

Tripartite meetings (between BNM, external auditor and banking institution) are usually held at least once a year and among the matters discussed include expectations on the role and responsibilities of external auditor, terms and scope of audit engagement for the following financial year, independence/internal governance of audit firm, issues arising from audit

(interim, year-end audit, limited review, special purpose audit and agreed upon procedures) and implementation of new FRSs.

The BNM also holds meetings with all external auditors to clarify supervisory expectations. Two meetings were held in the past year, one focused on expectations regarding FRS 139 and another focusing on expectations regarding internal risk management processes.

External auditors confirmed to the assessors that the three types of meetings mentioned under this EC actually take place.

AC 2 External auditors are required under section 40(15) of BAFIA, in the course of his audit to report immediately to BNM on the following:

- There has been a contravention of any provision of BAFIA or that any offence which relates to dishonesty or fraud under any other law which has been committed by the institution or by any other person;
- Losses have been incurred by the institution which reduce its capital funds to an extent that the institution is no longer able to comply with minimum regulatory capital requirements specified by BNM under section 37(1) of BAFIA;
- Any irregularity which jeopardizes the interests of depositors or creditors of the institution, or any other serious irregularity, has occurred; or
- He is unable to confirm that the claims of depositors or creditors are covered by the assets of the institution.

There is however currently no provision in BAFIA to provide protection to external auditors who make any such reports to BNM in good faith for breach of a duty of confidentiality. No reports have been made to the BNM under this provision.

AC 3 Paragraphs 4.2(v) of the Guidelines on Appointment of External Auditors for

	<p>Banking Institutions and Guidelines on Appointment of External Auditor by Islamic Banks prohibits an audit partner from serving as an engagement partner for a continuous period of more than 5 years with the same banking institution. An auditor who has been rotated off the audit of a banking institution may resume the role as engagement partner only after a lapse of 5 years from the last audit engagement with the institution. However, there is no requirement for the rotation of audit firms. The independence and objectivity of the audit firm is managed through rotation of the audit engagement partners and assessing the materiality of the non-audit services provided by the audit firm, e.g., tax and consulting services.</p> <p>AC 4 Under Pillar 3, banking institutions are required to have in place a disclosure policy approved by the board which defines the approach in determining the content (including the appropriateness), materiality, frequency of public disclosures and internal controls over the disclosure process.</p> <p>AC 5 Section 40(17) of BAFIA empowers BNM to access the external auditors' books, documents, accounts and transactions in relation to an audit of a banking institution.</p>
Assessment	Compliant
Comments	Feedback from market participants reflected a need for clearer communication of auditors' supervisory expectations to banks. Hence, assessors recommend the BNM more clearly communicate to banks its supervisory expectations in case additional procedures may be required on top of the normal audit procedures.
Principle 23	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	<p>EC 1: BNM's supervisory approach is heavily geared to early detection of emerging risks and vulnerabilities. At least once a year, a supervisory letter is issued to each banking institution which details requirements/recommendations which the institution needs to address. The letter must be deliberated at the following Board meeting and a response provided to BNM within the timeline (typically six weeks, stipulated in the letter); the response needs to cover the status of the corrective actions required.</p> <p>For corrective actions that are pending completion, banking organizations are required to provide quarterly (or more frequently depending on the seriousness of the issues) progress reports. BNM supervisors assess progress through direct interaction with the bank and its board and/or through reviews and verifications by such outside independent parties as internal or external auditors. Failure to timely address issues can lead to the downgrading of the firm's designated intervention stage.</p> <p>EC 2: Problem banks would normally have a designated intervention of at least "3" (Advanced Intervention) under the SIG (which was revised during the BCP review, modifying some terminology); at this stage, BNM could apply more intense business restrictions, remove officers or directors no longer judged to be fit and proper, and subject the firm to further supervisory or mandated external reviews; contingency planning to deal with possible resolution would be undertaken. It will be working very directly with PIDM, whose involvement would have begun in Stage 2. If the firm is then designated a "4" (Restructuring), BNM would direct the Board and controlling shareholders to seek a merger partner or prospective buyer. If that is not leading to a solution, BNM can make a non-viability determination under criteria it worked out with</p>

	<p>PIDM. Subsequent failure to resolve concerns would cause the firm to be rated “5” (Resolution), where efforts would be geared to resolution. The non-viability assessment is geared to the bank, not for example an FHC.</p> <p>EC 3: BNM looks to intervene early when problems are beginning but does have authority to take a range of possible actions if problems increase. Under Section of BAFIA, BNM can take formal enforcement actions against a bank, its board, and its officers when the need arises. When there is a contravention of law or of requirements imposed by BNM, BNM can impose penalties on institutions and initiate criminal proceedings with the appropriate authorities under Sections 103 and 106 of BAFIA.</p> <p>Under Section 7 of BAFIA, the MOF can revoke licenses upon the recommendation of the BNM. BNM has not needed to take formal actions during the past five or more years.</p> <p>EC 4: Under SIG, BNM has a menu of corrective actions it can take that correspond to the various intervention stages of SIG. Under Stage 2 “Early Intervention”, BNM can impose business restrictions and direct compliance actions be taken. These could include such actions as restricting current activities and prohibiting expansion of activities, and barring dividend payments. Under Stage 3, officers and directors can be removed. Under Stage 4, the bank can be directed to restructure or seek out a merger partner or acquirer. Under its recently revised SAA with the PIDM, BNM can make a determination of non-viability of a bank under agreed upon criteria; such discretionary criteria are not reflected in law or in other public documents.</p> <p>EC 5: Section 37 of BAFIA requires a bank to maintain a capital ratio determined to be appropriate by BNM. Section 73 of BAFIA empowers BNM to take necessary enforcement action to ensure safe and sound operations, including directing an institution to increase its capital to an appropriate level in relation to its risk profile.</p> <p>EC 6: Under Sections 103 and 106 of BAFIA, BNM can initiate with appropriate authorities criminal penalties and punishment on relevant officers and directors of banks. In practice, BNM has generally focused more on removal such individuals from their positions (or for directors, more often not extending their terms), unless fraudulent intent is seen in their actions.</p> <p>AC 1: There are no legal provisions that explicitly address the possibility that BNM supervisors will be slow in addressing problems. However, the structure of managerial oversight over the supervisory process, including the checks and balances provided by the panel review process (involving peers and superiors from different areas within supervision) limits the likelihood of this occurring.</p> <p>AC 2: BNM is able to prevent the payment of dividends from the parent to its parent. More broadly it can ring fence the bank under Section 73 of BAFIA including terminating related party agreements and subjecting all related party transactions to the prior approval of BNM. While its FHC authority is not strongly provided for in the law, it can direct designated FHCs to comply.</p> <p>AC 3: BNM has an MOU with the SC that requires coordination in their oversight of investment banks. However, the MOU does not require it to notify SC of actions taken on the bank affiliate of an investment bank, although the SC is copied on supervisory letters.</p>
Assessment	Largely Compliant
Comments	<ul style="list-style-type: none"> Look to strengthen the legislative basis for the determination of non-viability it is required to make for troubled banks.

	<ul style="list-style-type: none"> • Determine the resolution approach for FHCs. • Revise its MOU with the SC to strengthen the requirement on BNM to notify the SC of actions being applied to the bank affiliate of an investment bank or asset management company. BNM and SC are in the process of enhancing the MOU, which will provide for greater coordination and cooperation between them with regard to information sharing, and the conduct of examinations by BNM of entities licensed by the SC. • Expand the penalties that can be imposed on individuals under Civil Law.
Principle 24	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	<p>EC 1: Of the eight local banking groups that dominate the Malaysian banking market, six are FHCs with a parent holding company and various cross stream affiliates of the bank; the other two have a bank as the top tier entity (BHCs). A number of the cross stream affiliates are themselves directly regulated in whole or in part by the BNM (e.g., investment banks, Islamic banks, insurance companies) although some affiliates (asset management companies, unit trusts) are not regulated by the BNM (although for all FHCs, the extent of the activity in such affiliates is small). In actuality, almost all of the assets of the FHCs are in their bank subsidiaries, with no FHC having as much as 5% of its assets accounted for by non-bank subsidiaries. Moreover, virtually all of this limited amount of non-bank assets are in subsidiaries supervised by BNM (insurance) or the SC (asset management).</p> <p>The supervisory focus is clearly on the licensed entities within groups. However, BNM, as a result of recent changes, now reaches beyond the bank to get information on the organizational structure of the group, on its governance (including the composition of its board and its committee structure), on the business activities and financials of material entities in the group, on inter-company transactions, and various risk, audit, performance, and compliance reports of the group. It has developed the legal reach to do so by imposing conditions on BNM approvals (reviewed by the assessors) by the parent to invest in shares of the bank. The conditions imposed include requiring the FHC obtain approval of BNM: for the appointment of the CEO, the Directors and Chairman and to make acquisitions or changes in its capital; a further and broader condition is that the FHC must comply with guidelines issued by BNM. BNM also relies on provisions of BAFIA such as Sections 113(1) and 79 to oversee affiliates of a bank.</p> <p>EC 2: Section 113(1) of BAFIA empowers the BNM to obtain information from entities related to a bank. Section 79 of BAFIA extends the examination reach of the BNM to include related entities of the bank. However, explicit powers to supervise FHCs and their related entities do not currently exist, although the prospective law change would provide such authority.</p> <p>EC 3: The BNM uses the information it gathers (as described in EC 1) to determine if the non-banking activities of the banking/financial group pose any significant risks to the licensed banking entities. It looks to assess the financial condition of each material non-banking entity and to evaluate the level of oversight performed by the group's risk control functions over material non-banking entities. The assessors reviewed the key supervisory documents including review notes of several banking groups, including the most diversified FHC, and found that the focus does include consideration of</p>

consolidated risk management and control issues. For example, the supervisory plan for that FHC includes 19 reviews for 2012, and over half (10) are group-wide reviews (including operational risk management, compliance, and the compensation framework).

EC 4: BNM has no specific power to issue prudential regulations over FHCs. It has required BHCs to deduct investments from capital but there are no specific regulatory capital requirements over FHCs; there are reviews done in broad terms of the leverage ratios of FHCs. As noted in EC 1, some requirements are accepted by FHCs as a condition of being designated. Financial information is collected and used to assess group-wide financial condition.

EC 5: BNY has a limited formal information exchange with the SC domestically, and a more comprehensive one with the foreign supervisors which are most important for the host country operations of Malaysian banks.

EC 6: All banking institutions and FHCs are required to obtain BNM approval for all equity investments and for expanding operations in and outside of Malaysia; one of the conditions of approval referred to above applies a similar requirement to FHCs. The prospective new legislation would make this formal.

EC 7: The foreign activity of a Malaysian is treated as a “significant activity”, and thus subject to the set of supervisory practices for such activities. Relevant reporting and accountability structures are reviewed, the level of effective parental control is assessed, and the effectiveness of risk management structures analyzed.

EC 8: BNM gives heavy focus to the comprehensiveness, frequency, and timeliness of the reporting from foreign operations. BNM supervisors assess the effectiveness of management by the parent of foreign operations through the review of the key performance indicators imposed on the local management. Among the areas addressed in the licensing process is the ease and scope and information flow from the overseas operation to the parent bank.

EC 9: BNM does not have the authority to require the closing of foreign offices or to impose conditions on their activities. While the applications process allows for a before the fact judgment on the viability of overseas operations, problems can of course subsequently arise, which BNM cannot currently directly address. Some of these issues will be addressed with the law change.

EC 10: BNM assesses the level of parent bank oversight of foreign operations as part of its ongoing supervisory process, with higher expectations for the oversight of higher risk activities.

AC 1: As a condition to becoming a designated FHC, the FHC is required to only engage in financial services related activities and to obtain BNM’s approval for any equity investment and changes in its capital structure. The FHC is subjected to the BNM’s requirements regarding the appointment/re-appointment of its CEO/directors and requirements on independent directors.

AC 2: BNM has appropriate understanding of the supervisory frameworks of those countries in which Malaysian banks have material operations (most importantly, Singapore, Indonesia, Hong Kong, and Thailand).

AC 3: Using the principles of SuRF, BNM supervisors identify material risks in foreign operations, and determine what action then to take. The array of actions available include: communicating the concerns to the parent, conducting an on-site examination, and requiring specific reporting to be made to BNM. In the past two years, nine

	examinations were conducted in five different Asian countries.
Assessment	Largely Compliant
Comments	<p>BNM has been creative and largely effective in putting in place and implementing a consolidated supervisory framework despite obvious shortcomings in the enabling legislation as it applies to FHCs. BNM recognizes the need to address the legislative shortcomings, which would be extremely helpful, although some specific supervisory changes are also recommended.</p> <ul style="list-style-type: none"> • Needs to move quickly to put in place explicit legislative authorities for oversight and supervision of FHCs. • Whether under the current or new legislation, formalize the application of prudential regulatory provisions to the consolidated organization. • Needs to strengthen its guidance for the assessment of parent companies. • The MOU with the SC should be broadened to provide for SC sharing with BNM of information on asset management companies and other affiliates of a bank. • BNM should have the authority to require the closing of foreign offices or to impose conditions on their activities.
Principle 25	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	<p>EC 1: BNM has a strong set of information sharing arrangements with foreign supervisors, covering well the foreign operations of Malaysian banks and the foreign banks with operations in Malaysia. Under BNM’s Standard Operating Procedures describing its “Home-Host Supervisory Cooperation Framework”, BNM must engage with all regulators of foreign subsidiaries and branches and with all home supervisors of foreign financial institutions operating in Malaysia—with the mode and frequency of engagement driven by the following factors: the significance of the operations and activities; nature of new developments and emerging issues; areas for collaborative work; and such other considerations as flows dictated by an MOU, licensing process, or relationship building.</p> <p>Information on financial condition and new developments and issues affecting banks with cross border operations are shared pursuant to formal and informal information sharing arrangements, bi-lateral and multi-lateral meetings, and coordinated examination activities. BNM also has a very active program of overseas examinations, sending people on a regular schedule (annual, biannual, tri-annual depending on the size and nature of operations in particular countries) and an ad hoc basis as needed. BNM also does coordinated examinations work with the MAS (such as joint model validation) and with authorities in Cambodia. It has made significant efforts to implement training programs for other supervisors in the region.</p> <p>EC 2: BNM has put in place a variety of means to ensure effective information flow. BNM has entered into MOUs with four countries (Indonesia, Cambodia, Vietnam, and China) to add to less formally structured but well functioning such other relationships with Singapore, Hong Kong, UK, and Canada. It has hosted two supervisory colleges and participated in colleges hosted by authorities in Hong Kong, Germany, Canada, China,</p>

	<p>UK and Singapore. These various approaches cover well the major areas of foreign operations – total of 20 countries, with only 12 having more than a single office or subsidiary of Malaysian banks.</p> <p>EC 3: As a home supervisor, BNM shares information with host jurisdictions on its supervisory processes and on specifics of the consolidated bank’s risk assessment. In one country where Malaysian banks are particularly major players in another country’s banking market (Cambodia) BNM supplements the information exchange with training programs and coordinated reviews with the host country’s supervisory authority.</p> <p>EC 4: Under BNM’s SOP for Home-Host Supervisory Cooperation, it provides the CRR for the locally incorporated (the only form of entry allowed) subsidiaries of foreign banks to the home country supervisor, responds to ad hoc requests, and engages in dialogues in meetings and over the phone.</p> <p>EC 5: The locally incorporated subsidiaries of foreign banks are subject to the same regulations, reporting, and supervisory processes as are locally owned banks. However, they are subject to branching distribution ratio requirement on opening of new branches.</p> <p>EC 6: As part of the licensing process, BNM solicits information from the home supervisor on its supervisory approach as well as on whether there are legal impediments to the parent bank providing further financial support to the Malaysian subsidiary. BNM also advised that it reviews FSAP assessments on the quality of consolidated supervised practiced by the home country although it does not do a formal independent assessment.</p> <p>EC 7: BNM allows access to home country supervisors to carry out their intended reviews of Malaysian bank subsidiaries. It requires prior notice of intention, and then establishes a protocol for the home country authority to meet with BNM both prior to and following its examination to share insights.</p> <p>EC 8: Shell banks are not allowed in Malaysia, and BNM has taken steps to prevent indirect access to the Malaysian banking system through for example, correspondent banking relationships.</p> <p>EC 9: BNM’s procedures provide for consultation with the home country supervisor before acting on information received from such supervisor. To date, no such action has been found to be necessary.</p> <p>AC 1: BNM has developed communication channels with host jurisdictions, that could be activated in the event of needed follow-up actions.</p>
Assessment	Compliant
Comments	<p>BNM has a very developed program of information exchange and supervisory cooperation with an appropriate set of foreign supervisors. BNM has been in the forefront of offering training programs for supervisors in the region. A couple of recommendations:</p> <ul style="list-style-type: none"> • In licensing foreign bank subsidiaries, BNM should do a formal independent assessment of consolidated home country supervision. • BNM should enter into MOUs with countries where there are significant new entrants.

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

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation		
1.1 Responsibilities and objectives	C	<p>Laws are in place for banking and the role of BNM is clearly defined. Clear responsibilities and objectives for other authorities are also in place.</p> <p>The BNM has issued the “Financial Sector Blueprint 2011-2020”, a strategic plan that lays out the future direction of the Malaysian financial system.</p> <p>The assessors recommend the BNM uses stronger language in its guidelines and recommendations, clearly stating that banks “must” observe the regulatory requirements instead of “shall” observe the regulatory requirements. This will be addressed by the BNM’s Policy Development Framework which was rolled out for implementation on 17 May 2012.</p>
1.2 Independence, accountability and transparency	LC	<ul style="list-style-type: none"> • Transparency in the policy activities of the BNM could be increased. This will be achieved by the adoption of the new Policy Framework. • Governance arrangements (including operational procedures) and the roles/responsibilities of various functions within the BNM have yet to be disclosed to the public for clarity and accountability. <p>There are some instances in legal framework where the Minister could interfere with BNM’s independence. For example, Section 70 in BAFIA allows the Minister at any time to direct the Bank to make an examination of the books or other documents, accounts and transactions of any licensed institution if he has certain suspicions with regard to a banking institution. Also, Section 15 of BAFIA allows companies to use the word “bank”, “banking” (...) or any derivatives of this word with the explicit approval of the Minister. Furthermore, Section 73 of BAFIA authorizes BNM to direct institutions to take corrective actions, with the concurrence of the Minister remove and/or appoint new officers and directors; the BNM can also recommend to the Minister the revocation of a banking license and approval of transfer of significant ownership.</p>

Core Principle	Grading	Comments
		In practice, however, the assessors have not come across evidence of Government interference which would seriously compromise the independence of the BNM. It would provide greater certainty regarding the independence of the BNM if these provisions were removed and the independence of the BNM were formally grounded in the law.
1.3 Legal framework	C	<ul style="list-style-type: none"> • The BNM will further enhance transparency by wider public consultation on proposed policy measures in accordance with the Policy Development Framework. • For the sake of transparency, the BNM should align the terminology used in its regulations. Circulars, guidelines and best practices are generally considered binding for banks and there may not be any need to distinguish between them.
1.4 Legal powers	C	BNM has the authority to address compliance with laws and safety and soundness concerns through a broad grant of legislative authority.
1.5 Legal protection	C	<p>Staff and persons appointed by the BNM are covered by the statutory immunity clause for any action taken in good faith in pursuance of their duties.</p> <p>The assumption of the legal cost for defending against lawsuits faced by individual supervisor could be anchored in the law.</p> <p>The legal coverage should not depend on the person's employment status at the time of the lawsuit; former employees should be explicitly included. Further, consideration should be given to include a provision permitting the BNM to indemnify these persons for their legal costs in the event they are sued.</p>
1.6 Cooperation	LC	<p>BNM has a good framework for information sharing with foreign supervisors, but information sharing arrangements could be improved through:</p> <ul style="list-style-type: none"> • expanding the MOU with the SC to cover more than the investment banks that the SC and BNM co-regulate (i.e. to include asset management companies), and provide for the SC to share information with BNM and for BNM to alert the SC of supervisory developments in the broader banking group that could affect those institutions within the group regulated by the SC.

Core Principle	Grading	Comments
		<ul style="list-style-type: none"> • more formalized information sharing with the SKM. • the BNM entering into MOUs with countries (e.g., Japan) of major new entrants.
2. Permissible activities	C	The existing legal and regulatory provisions appropriately define and control the business of banking, including, in particular, deposit-taking. There are some deposit-taking companies not regulated by BNM.
3. Licensing criteria	LC	<p>BNM has a conservative program for the granting of new licenses, where in the exception of the explicit inviting of companies to apply for a stipulated set of new licenses (as occurred in 2009), no applications for conventional commercial banks have been considered in forty years. New legislation (FSA) would, at such time as it is enacted, deal with many of the limitations in the current approach, listed below, but in any event, going forward BNM should address the following:</p> <ul style="list-style-type: none"> • Reflecting the infrequency with which applications have been entertained, the degree of transparency in the criteria to be applied has been less than in other countries and should be improved. • The focus of the application review was most heavily on the immediate applicant, although some review is done of ultimate shareholders. The criteria should explicitly include an assessment on the nature and sufficiency of financial resources and the integrity of the shareholder. • In the case of foreign banks, there is no explicit independent evaluation of the nature and degree of consolidated regulation and supervision applied by the home country supervisor, as review is focused essentially on available FSAPs. • Criteria on the suitability of officers (covering more of the senior team than the CEO) and the achievability of business plans need to be more explicit;
4. Transfer of significant ownership	LC	<p>The framework for controlling the ownership of banks is a good one, but should be refined:</p> <ul style="list-style-type: none"> • BNM must have the capacity to address

Core Principle	Grading	Comments
		<p>directly unauthorized acquisitions of shares, or control, of a banking institution, such as requiring divestitures and/or cessation of control.</p> <ul style="list-style-type: none"> • BNM should have an ability to learn about and deal with changes in the suitability of major shareholders.
5. Major acquisitions	LC	<p>Overall approach is effective but there are some improvement opportunities:</p> <ul style="list-style-type: none"> • BNM should look to codify criteria more explicitly for major acquisitions.; • BNM needs more explicit authority to take corrective action against non-banking companies that could be acquired if they subsequently prove to be detrimental to the interests of the bank affiliate.
6. Capital adequacy	LC	<p>Banks remain well capitalized with system-wide risk-weighted capital ratio and core capital ratios at 14.9 percent and 12.9 percent respectively in 2011.</p> <p>The scope of application of the capital framework should be widened to include financial holding companies, as outlined in the Basel II scope of application.</p> <p>Some other, but minor, amendments to fully align the capital framework with the BCBS standards should also be made. The assessors, however believe the impact not to be material, particularly in view of the other areas where the BNM is stricter than the Basel minimum.</p> <p>Basel II consists of three mutually reinforcing pillars; the BNM should therefore also fully implement Pillar 2 as soon as possible. Having a Pillar 1 and Pillar 3 in place without a fully fledged Pillar 2 process is, strictly speaking, not in line with the sound Basel II implementation.</p> <p>Moving forward, BNM will have enhanced legal powers under the new financial services legislation to enable the application of capital framework on financial holding companies and is in the process of fully aligning the definition of capital with the implementation of Basel III in Malaysia.</p>
7. Risk management process	LC	<p>BNM has a good framework for risk management, but there are some improvement opportunities:</p> <ul style="list-style-type: none"> • Increase the number and experience level

Core Principle	Grading	Comments
		<p>of risk specialists and ensure they spend more time in the field (currently, other than model validation reviews, such specialists only occasionally do on-site reviews);</p> <ul style="list-style-type: none"> • Ensure that under the current law that prudential risk management policies are explicitly and consistently applied to consolidated FHCs; • Ensure in particular that relevant stress tests are applied to consolidated FHCs. • BNM needs to issue a guideline that specifically requires banks to have a dedicated unit responsible for the risk management process.
8. Credit risk	C	The regulations as well as the supervisory framework cover the overall credit risk process in terms of identification, management and mitigation.
9. Problem assets, provisions, and reserves	C	<p>BNM is in compliant with Principle 9. BNM issued comprehensive guidelines specifying the requirements and regulatory expectations for banking institutions to have in place an effective system for management of problematic assets and processes to ensure the adequacy of provisions and reserves.</p> <p>In the event that BNM has supervisory concerns over banking institution's asset quality and adequacy of provisions, BNM has the power to require banks to increase the level of provisions and reserves as well as banking institutions financial strength via higher minimum capital requirements.</p>
10. Large exposure limits	LC	<p>Generally speaking, laws, guidelines and supervisory practices are in place to ensure banking institutions' large exposures are prudently managed.</p> <p>Some enhancements can be made in the following areas:</p> <ul style="list-style-type: none"> • a more comprehensive definition of "a group of connected counterparties" including the notion of economic dependency; • a more active use of Pillar 2 to identify and assess credit concentrations; and • the alignment of the large exposure limits

Core Principle	Grading	Comments
		<p>with international best practice</p> <p>The BNM is planning to issue a revised guideline for credit concentrations: The revised guideline is expected to comprehensively address all the requirements of Principle 10. Specifically, the enhancements to the guidelines include:</p> <ul style="list-style-type: none"> • Clear and specific risk management expectations on compliance with the prudential limits; and • Comprehensive guidance on determining interconnectedness of counterparties; • Review of prudential limits; and • Guidance on measurement of exposures to properly reflect exposures and ensure consistency.
11. Exposure to related parties	LC	While the overall approach to connected lending is generally sound, the exclusion of some significant minority shareholders is a gap that should be addressed.
12. Country and transfer risks	LC	<p>Although the assessors are broadly satisfied that country risk is identified and assessed on a timely basis as part of the supervisory framework, there is a need for more explicit legal and regulatory requirements on banks in the area of country and transfer risk. With the growing internationalization of the Malaysian banking system, the BNM should expect that country and transfer risk be managed as a separate risk category.</p> <p>The BNM is to be commended for its periodic internal reporting on country risk.</p>
13. Market risks	C	<p>The regulatory guidelines are comprehensive and clear with regard to the trading book.</p> <p>The assessors recommend more market risk specialists are trained in market risk.</p> <p>The assessors recommend the risk specialist accompany the supervisor on onsite examinations for higher risk institutions.</p>

Core Principle	Grading	Comments
14. Liquidity risk	LC	<p>The regime for bank liquidity risk management is a sound one, but improvements could be made in the application of the regime to FHCs.</p> <ul style="list-style-type: none"> • BNM supervisors need to conduct ongoing reviews of FHC consolidated liquidity • BNM needs to require that an FHC conducts a consolidated liquidity stress test and table the stress test results at ALCO.
15. Operational risk	LC	<p>Although high level operational risk management requirements are generally in place and adhered to, the assessors recommend</p> <ul style="list-style-type: none"> • the release of more detailed regulation • the training of more supervisors in the operational risk specialist risk stream • operational risk specialists attend on site examinations for higher risk institutions. <p>BNM is currently developing an Operational Risk Reporting System to upgrade eFIDS into a full-fledged operational risk event and loss reporting system, for increased surveillance capability as well as for information sharing with the industry. This will include revision to the fraud taxonomy to cater for fraud events that are inherent in investment banking activities. The system is expected to be operational in the first quarter of 2013.</p> <p>The BNM is already addressing the first recommendation by drafting the Operational Risk Management Guidelines. The guidelines will also mandate the reporting of all operational risk loss events.</p>
16. Interest rate risk in the banking book	LC	<p>The assessors reviewed the assessment of IRRBB as part of their review of a number of supervisory files and were satisfied with the depth and scope of the individual institutions' and horizontal reviews. That said:</p> <ul style="list-style-type: none"> • There is currently no regulation addressing IRRBB; and • Feedback from banks indicated this is an area where supervisory expectations need to be clarified; and • More specialists need to be trained in IRRBB and they should attend the onsite

Core Principle	Grading	Comments
		inspections for higher risk institutions.
17. Internal control and audit	C	BNM has a strong program for ensuring that effective governance, staffing, and processes are in place for the important control functions of a bank. The BNM focuses heavily and effectively on offering director training programs.
18. Abuse of financial services	C	The assessors recommend AML/CFT Specialists join onsite BNM supervisors for the examination of higher risk banks.
19. Supervisory approach	C	<p>BNM has a well developed framework of supervision with a strong mechanism to ensure effective and consistent analysis of risks, with access to a variety of information sources to keep its assessments current. We have several recommendations for improvement:</p> <ul style="list-style-type: none"> • Increase the number and experience level of risk specialists and provide for their spending more time in the field; • Revisit its methodology for assigning ratings to banks to provide capacity to factor in more explicitly adverse effects from affiliates.
20. Supervisory techniques	C	BNM has a strong and well structured supervisory program, using appropriate supervisory techniques.
21. Supervisory reporting	C	<p>The assessors recommend BNM require at least annual physical sign off of the prudential returns by the Senior Management of the bank. The BNM is currently enhancing its on-line statistical reporting (i.e. the Integrated Statistical System (ISS) Project) to incorporate a digital signatory requirement by senior management for each submission by the banks.</p> <p>While the assessors commend the BNM for the legal provisions with regard to the power of the BNM to require adjustments to the financial statements and to obtain supporting evidence, they recommend BNM discontinue the use of Section 41 (4) of Bafia. This specific article requires the BNM to inform the banking institution in writing that the financial statements and supporting documents are satisfactory in terms of form and content. This requirement somehow interferes with the independence and responsibility of the external auditor and unduly exposes the BNM to reputational risk.</p>
22. Accounting and disclosure	C	Feedback from market participants reflected a need for clearer communication of auditors' supervisory expectations to banks. Hence, assessors recommend the BNM more clearly communicate to banks its supervisory

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

Core Principle	Grading	Comments
		<p>supervisors. BNM has been in the forefront in offering training programs to other supervisors in the region. Some recommendations for improvements;</p> <ul style="list-style-type: none"> • In licensing foreign banks subsidiaries, BNM should do a formal independent assessment of consolidated home country supervision. • BNM should enter into MOUs with countries that have major new entrants.
<p><i>Aggregate:</i> Compliant (C) – #, Largely compliant (LC) – #, Materially noncompliant (MNC) – #, Noncompliant (NC) – #, Not applicable (N/A) – #</p>		

III. RECOMMENDED ACTION PLAN AND AUTHORITIES' RESPONSE TO THE ASSESSMENT

A. Recommended Action Plan

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

Reference Principle	Recommended Action
<p style="text-align: center;">Objectives, Independence, Powers, Transparency and Cooperation (CP1)</p>	<ul style="list-style-type: none"> • Use stronger language in guidelines and recommendations, clearly stating that banks “must” observe the regulatory requirements instead of “shall” observe the regulatory requirements. • Remaining provisions in law requiring consultation with the Minister for supervisory actions should be removed and the independence of the BNM formally grounded in the law. • Expand the MOU with the SC to: cover more than the investment banks that the SC and BNM co-regulate (i.e., to include asset management companies and unit trusts which can also be part of banking groups); provide for SC to share information with BNM on entities it supervises within FHCs; and provide for BNM alerting the SC to supervisory developments in the broader banking group that could affect those institutions within the group regulated by the SC • Enter into more formalized information sharing arrangements with the SKM; • Enter into MOUs with countries (e.g., Japan) of major new entrants. • Expand legal coverage so that former employees are explicitly included. Consider including a provision permitting the BNM to indemnify these persons for their legal costs in the event they are sued.

<p>Licensing criteria (CP3)</p>	<ul style="list-style-type: none"> • Reflecting the infrequency with which applications have been entertained, the degree of transparency in the criteria to be applied has been less than in other countries and should be improved. • The focus of the application review was most heavily on the immediate applicant, although some review is done of ultimate shareholders. The criteria should explicitly include an assessment on the nature and sufficiency of financial resources and the integrity of the shareholder. • In the case of foreign banks, there is no explicit independent evaluation of the nature and degree of consolidated regulation and supervision applied by the home country supervisor, as review is focused essentially on available FSAPs. • Criteria on the suitability of officers (covering more of the senior team than the CEO) and the achievability of business plans need to be more explicit; (the draft FSA, if enacted, will require the latter)
<p>Transfer of Significant Ownership (CP4)</p>	<ul style="list-style-type: none"> • BNM must have the capacity to address directly unauthorized acquisitions of shares, or control, of a banking institution, such as requiring divestitures and/or cessation of control. • BNM should have an ability to learn about and deal with changes in the suitability of major shareholders.
<p>Major Acquisitions (CP 5)</p>	<ul style="list-style-type: none"> • BNM should codify criteria for major acquisitions; • BNM needs more explicit authority to take corrective action against non-banking companies that could be acquired if they subsequently prove to be detrimental to the interests of the bank affiliate.
<p>Capital adequacy (CP6)</p>	<ul style="list-style-type: none"> • Expand the scope of application of the capital framework to include financial holding companies, as outlined in the Basel II scope of application. • Make amendments to fully align the capital framework with the BCBS standards • Fully implement Pillar 2.
<p>Risk Management Process (CP 7)</p>	<ul style="list-style-type: none"> • Increase the number and experience level of risk specialists and ensure they spend more time in the field, performing on-site review particularly at large and complex banks; • Ensure that prudential risk management policies are explicitly and consistently applied to consolidated FHCs, as is provided for under the draft FSA;

Risk Management Process (CP 7)	<ul style="list-style-type: none"> • Ensure in particular that relevant stress tests are applied to consolidated FHCs. • BNY needs to issue guidance on the requirement for firms to have separate risk management units.
Large Exposures (CP10)	<ul style="list-style-type: none"> • Fully use Pillar 2 to identify and assess credit concentrations;
Related Parties (CP 11)	<ul style="list-style-type: none"> • Reassess the change made to the definition of connected parties in 2008, excluding significant (20%-50%) shareholders (unless they had a director) and their subsidiaries and associated companies, from the definition
Country Risks (CP 12)	<ul style="list-style-type: none"> • Introduce more explicit legal and regulatory requirements on banks in the area of country and transfer risk.
Market Risk (CP 13)	<ul style="list-style-type: none"> • Strengthen the supervisory framework by letting market risk specialist participate in on site exams for higher risk institutions
Liquidity Risk (CP 14)	<ul style="list-style-type: none"> • BNM supervisors need to conduct ongoing reviews of FHC consolidated liquidity • BNM needs to require that an FHC conducts a consolidated liquidity stress test and table the stress test results at ALCO.
Operational Risk (CP 15)	<ul style="list-style-type: none"> • Release more detailed regulation and supervisory expectations in the area of operational risk. • Train more specialists in operational risks specialist risk stream let them accompany supervisors on onsite examinations, particularly for higher risk institutions.
Interest Rate Risk in the Banking Book (CP 16)	<ul style="list-style-type: none"> • Release more detailed regulation and supervisory expectations in the area of interest rate risk in the banking book. • Implement Pillar 2 fully.
Abuse of Financial Services (CP18)	<ul style="list-style-type: none"> • Let AML/CFT specialists accompany supervisors during on site examinations, particularly for high risk institutions.
Supervisory Approach (CP 19)	<ul style="list-style-type: none"> • Increase the number and experience level of risk specialists and provide for their spending more time in the field; • Revisit methodology for assigning ratings to banks to provide capacity to factor in more explicitly adverse effects from affiliates

<p>Supervisory Reporting (CP 21)</p>	<ul style="list-style-type: none"> • Require at least annual physical sign off of the prudential returns by the Senior Management of the bank. The BNM is currently enhancing its on-line statistical reporting (i.e. the Integrated Statistical System (ISS) Project) to incorporate a digital signatory requirement by senior management for each submission by the banks. • Discontinue the use of Section 41 (4) of BAFIA. This specific article requires the BNM to inform the banking institution in writing that the financial statements and supporting documents are satisfactory in terms of form and content. This requirement somehow interferes with the independence and responsibility of the external auditor and unduly exposes the BNM to reputational risk. (This provision is sought to be removed in the proposed FSA).
<p>Accounting/Disclosure (CP 22)</p>	<ul style="list-style-type: none"> • Ensure clear communication to banks in case additional external audit procedures are required
<p>Supervisors' Corrective and Remedial Powers (CP 23)</p>	<ul style="list-style-type: none"> • Look to strengthen the legislative basis for the determination of non-viability it is required to make for troubled banks. • Determine the resolution approach for FHCs. • Revise its MOU with the SC to strengthen the requirement on BNM to notify the SC of actions being applied to the bank affiliate of an investment bank or asset management company. • Expand the penalties that can be imposed on individuals under Civil Law.
<p>Consolidated Supervision (CP 24)</p>	<ul style="list-style-type: none"> • Put in place explicit legislative authorities for oversight and supervision of FHCs. • Whether under the current or new legislation, formalize the application of prudential regulatory provisions to the consolidated organization. • Strengthen the guidance for the assessment of parent companies. • The MOU with the SC should be broadened to provide for SC sharing with BNM of information on asset management companies and other affiliates of a bank. • BNM should have the authority to require the closing of foreign offices or to impose conditions on their activities.
<p>Home-Host relationships (CP 25)</p>	<ul style="list-style-type: none"> • In licensing foreign bank subsidiaries, BNM should do a formal independent assessment of consolidated home country supervision • BNM should enter into MOUs with countries (e.g., Japan) with major new entrants.

B. Authorities' Response

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

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

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

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