Prudential Regulation and Supervisory Framework

59 Introduction
59 Regulatory Developments
63 White Box: Implementation of Risk-Based Capital Framework for Insurers
68 Supervisory Assessment
71 Priorities Moving Forward

Prudential Regulation and Supervisory Framework

INTRODUCTION

Bank Negara Malaysia continued to focus on strengthening the pillars of a sound prudential regulatory framework in 2008. Despite the highly volatile market conditions and the global financial turmoil, the Malaysian financial sector remained resilient. This has been supported by the underlying strength of the system built through extensive regulatory reforms undertaken over the years following the Asian financial crisis in 1997, and the continuing rigorous supervision of financial institutions. An appropriate balance between principle-based and rule-based regulations which characterises the prudential regulatory framework has also promoted the orderly growth of the various components of the domestic financial sector. Against the backdrop of the current global financial turmoil, the critical importance of this balance is clear in ensuring that financial innovation does not outstrip the capacity of the financial system to manage the associated risks. While maintaining this balance, ongoing enhancements to the regulatory framework will continue to be pursued, in line with changes that are taking place at the international level.

The Malaysian financial sector remained resilient, supported by the underlying strength of the system built through extensive regulatory reforms and the continuing rigorous supervision of financial institutions

Throughout the year, the Bank's supervisory activities were responsive to developments unfolding on the global front. The Bank's supervisory resources remained in a state of heightened alert as the external environment continued to deteriorate, with greater attention directed towards focused risk assessments and stress testing, both at the micro and macro levels, to detect vulnerabilities of the financial sector to further shocks. This has supported a forward-looking view of the financial sector and enabled the Bank to take pre-emptive actions in ensuring that financial institutions have in place effective plans, including capital plans, to respond to any possible shocks.

REGULATORY DEVELOPMENTS

The continued stability of the domestic financial sector in 2008 allowed further progress to be achieved in ongoing efforts to strengthen the regulatory framework. This work has been mainly directed at updating and reinforcing existing regulations in light of the changing market environment, aligning the prudential standards with international best practices, and consolidating the regulatory framework across financial activities and sectors.

The unprecedented nature and scale of the global financial crisis had, however, severely tested the adequacy and robustness of prudential frameworks around the world. In Malaysia, a sound regulatory framework that has been in place; particularly with respect to capital adequacy, liquidity risk management, the introduction of new financial products and the activities of investment banks; contributed towards averting the problems that were at the epicentre of the financial crisis. This framework reflects the Bank's commitment to a gradual process of progressive deregulation, whereby prescriptive rules and a more active supervisory role have been preserved where appropriate, in tandem with the Bank's assessment of the capacity of individual institutions and the system as a whole to manage and mitigate risks.

During the year, the emphasis of regulatory initiatives continued to be directed at promoting sound corporate governance and risk management practices, and the implementation of more robust capital adequacy regimes across the key sectors of the financial services industry. The implementation of Basel II for banking institutions in 2008 and the Risk-Based Capital (RBC) Framework for insurers in 2009 were significant milestones in putting the mainstays of the financial sector on firmer footing. The prudential framework was also brought into greater alignment with the International Financial Reporting Standards (IFRS) following revisions

to valuation standards applicable to insurance companies. The proposed Central Bank of Malaysia Act will further strengthen a solid foundation for both micro-prudential and macro-prudential stability.

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The following sections highlight key developments in the prudential regulatory framework in 2008.

Capital adequacy

Basel II and the Capital Adequacy Framework for Islamic Banks (CAFIB) were implemented smoothly on 1 January 2008. The key components of Basel II and CAFIB are depicted in Table 3.1. The Basel II framework adopted in Malaysia is consistent with the framework developed by the Basel Committee on Banking Supervision (Basel Committee), with national discretion exercised where appropriate based on prudential considerations to reflect domestic circumstances. 43 banking institutions have opted to adopt the Standardised Approaches for determining their regulatory capital requirements. The remaining 13 banking institutions which have been given approval to adopt the Internal Ratings-Based (IRB) Approach for credit risk have been allowed to remain under the Basel I regime to comply with regulatory capital requirements until end-2009 in order to reduce the implementation costs associated with the transition to Basel II.

In August 2008, the Bank released a concept paper on the securitisation component of the Basel II framework based on the Standardised Approach for industry feedback. The concept paper builds on existing guidelines issued in 2003 which sets out risk management expectations and the regulatory treatment for banking institutions' involvement in asset-backed securitisation activities, and proposes more risk-sensitive minimum capital requirements for securitisation exposures, including off-balance sheet exposures to special purpose vehicles (SPVs), taking into consideration the rating, maturity and seniority of such exposures. In addition, the framework also calls for more stringent disclosure requirements on structures that provide for implicit recourse by investors to the originating banking institutions for exposures held, thus enhancing market assessments of the potential risk exposures of banking institutions. The Bank is in the process of examining industry feedback received in response to the concept paper before finalising the framework for implementation in 2009. Based on the feedback received, further refinements to the framework will consider additional guidance to facilitate the assessment of whether an effective transfer of risk has taken place in a securitisation transaction for the purpose of according regulatory capital relief. As demonstrated by the crisis, this is critical to avoid arbitrage and ensure that adequate capital is held against securitisation exposures.

Table 3.1
Basel II and CAFIB: Available Approaches for Risk-Weighted Capital Ratio Computation from January 2008

Credit Risk	i) Standardised Approach
Market Risk	i) Standardised Approach ii) Internal Models Approach
Operational Risk	i) Basic Indicator Approach ii) Standardised Approach iii) Alternative Standardised Approach

With the substantial completion of work on the Standardised Approaches, resources were directed to prepare for the implementation of the IRB Approach for credit risk from 2010 in line with the timeline announced by the Bank. In July 2008, the Bank released details on the IRB Approach under the revised capital framework which are largely based on the document issued by the Basel Committee, with additional guidance setting out the supervisory expectations on the oversight roles of the

board and senior management, the validation of internal models and use test methodologies. The expectations on the board emphasise the critical need for boards to have, or be adequately supported by, the necessary competencies that will be required to effectively discharge their oversight responsibilities.

The option to adopt the IRB Approach was also extended to Islamic banks, thus enabling banks that are part of banking groups adopting the IRB Approach to leverage on group infrastructures and policies for determining regulatory capital. While the Islamic Financial Services Board has not issued any specific rules on the IRB Approach, it has provided national supervisors with the discretion to implement the IRB Approach for Islamic banks in their respective jurisdictions. The same principles and methodologies underpinning the Basel II IRB Approach for conventional banks have been adopted in Malaysia for Islamic banks. Notwithstanding the group-driven implementation of the IRB Approach by Islamic banks, Bank Negara Malaysia expects Islamic banks to implement effective oversight arrangements even at the entity level to support the successful migration to Basel II.

Engagements with banking institutions during the year sought to identify and address specific implementation challenges associated with the adoption of the IRB Approach that would, in turn, have a bearing on the adequacy of capital levels maintained by banking institutions. For example, different approaches have been taken by IRB banks in defining downturn economic conditions for purposes of estimating downturn loss given default (LGD) as well as in adjusting retail probability of default (PD) estimates to cater for seasoning effects. As potential differences in these interpretations between the Bank and individual institutions have significant implications for an institution's model development, validation and roll-out plans, the Bank will maintain close discussions with IRB banks throughout 2009 to facilitate the smooth execution of the IRB framework, while ensuring that banks adopt sufficiently rigorous approaches to the determination of risk parameters.

The supervisory review of banking institutions' IRB models is a continuing process and has intensified as banking institutions recalibrate existing rating models and roll out new ones. The supervisory review aims to ensure that regulatory capital levels maintained by banking institutions based on internal models are well supported by credible estimates of an institution's risk exposure, and comprehensive policies and processes to ensure that the models are robust. As part of the transition to the IRB Approach, banks will be required to commence reporting on their capital adequacy levels under the IRB Approach on a parallel basis in the second half of 2009. This transition will provide a further opportunity for banking institutions and Bank Negara Malaysia to test the robustness of internal models.

The supervisory review aims to ensure that regulatory capital levels maintained by banking institutions based on internal models are well supported by credible estimates of an institution's risk exposure, and comprehensive policies and processes to ensure that the models are robust

During the year, the Bank also issued guidance on the supervisory review process (Pillar 2) and disclosures on capital adequacy (Pillar 3), which form integral components of the revised capital adequacy frameworks, for industry feedback. Pillar 2 deals with risks that are not fully captured or addressed under Pillar 1 (such as interest rate risk in the banking book, concentration risk and residual risks). Central to Pillar 2 is the requirement for banking institutions to implement an effective and rigorous internal capital adequacy assessment process that is commensurate with the scale, nature and complexity of their operations. This is reinforced by Pillar 3 which is aimed at promoting more effective market discipline through enhanced disclosures on banks' capital adequacy levels relative to risk. The Bank expects to finalise these guidelines in 2009.

New workstreams on capital are also anticipated in light of the recent announcement by the Basel Committee to further strengthen certain aspects of the Basel II Framework in response to the crisis. This will include the tightening of

capital treatments for securitisation activities, a review of the use of ratings to drive capital charges, further Pillar 2 guidance and enhanced disclosures under Pillar 3. To varying degrees, the issues under consideration have been reflected in the development of the revised capital framework for banking institutions in Malaysia. For example, rigorous expectations regarding operational requirements that must be met in order to obtain capital savings from securitisation transactions have already been incorporated in the securitisation framework. Rating agencies are also subject to a formal recognition process that requires the agencies to demonstrate their observance of robust standards in rating approaches before their ratings may be used for purposes of determining regulatory capital. The Bank will continue to monitor international developments closely, with a view to further enhance the domestic framework after considering the implications of any proposed changes in the context of the domestic environment.

The implementation of the RBC Framework for insurers on 1 January 2009 completed an important component of the overall objective towards ensuring a strong capital foundation for the financial sector. The RBC Framework, which replaces the previous Margin of Solvency (MOS) regime, provides for capital assessments that are more aligned to the specific risk profiles of individual insurers, and reflective of market-consistent valuations. After a parallel run of almost two years during which the Framework underwent several refinements to enhance the integrity of the Framework, legislative changes were approved to bring the Framework into effect. Preliminary observations on the impact of the implementation of the RBC Framework are provided in the box article "Implementation of the Risk-Based Capital Framework for Insurers". Since the implementation of the Framework, further adjustments have been necessary to address the impact of market interest rates used in the valuation standards moving significantly out of line with historical norms. The Bank will continue to monitor market conditions closely in the current environment to ensure that the Framework parameters remain appropriate and relevant at all times. The year also saw preliminary groundwork laid for the development of a RBC Framework for takaful operators. The Bank expects to progress this work towards an industry consultation phase in 2009, focusing on the options and underlying Shariah precepts for designing a risk-based capital model for takaful operators.

Corporate governance

In line with the Bank's firm belief in continuing education as a key strategy to raise the bar on corporate governance, the Financial Institutions Directors' Education Programme (FIDE) was launched in November 2008. FIDE, which aims to support the development of highly effective boards of directors of financial institutions, is the culmination of a collaborative effort between the Bank, Malaysia Deposit Insurance Corporation (PIDM) and the International Centre for Leadership in Finance over a two-year period. The resulting programme offers a unique platform to tackle the specific challenges and issues that confront boards of financial institutions.

FIDE offers a unique platform to tackle the specific challenges and issues that confront boards of financial institutions

Drawing extensively on insights from the Bank's supervisory observations and feedback obtained directly from directors regarding the functioning of boards of financial institutions, FIDE's objectives are to deliver solutions that will: (i) strengthen the skill sets and knowledge of directors to effectively discharge their responsibilities; (ii) promote excellence in directors' performance; (iii) equip directors with a sound understanding of current issues and developments in the financial industry; (iv) create an environment for directors to learn from each other; and (v) build a deep pool of qualified independent directors to serve on the boards of financial institutions. The recent rise of bank and corporate failures globally due to inadequate oversight by the board and senior management affirms the relevance of these objectives.

FIDE's objectives are delivered through three complementary channels – an instructional and interactive education programme, an information sharing network, and a series of occasional talks and presentations on developments and

Implementation of Risk-Based Capital Framework for Insurers

The Risk-Based Capital Framework for Insurers (RBC) came into effect on 1 January 2009 after almost two years of parallel run with the previous solvency regime from April 2007. The framework aims to better align the regulatory capital requirements with the underlying risk exposure of each individual insurer, improve the transparency of prudential buffers, and allow greater flexibility for insurers to operate at different risk levels that are commensurate with risk management infrastructure and practices. A new set of valuation rules was also introduced to ensure that assets and liabilities are valued in a realistic and market-consistent manner.

A key objective of RBC is to ensure that prudential buffers reflect the underlying risk profiles of individual insurers. To achieve this, RBC requires more explicit quantification of the various risks inherent in the insurance business. This provides insurers with an additional tool to manage business more effectively, by identifying the sources of risk, and implementing the appropriate measures to mitigate, manage or remove risks. In the long run, having an improved understanding of the relationship between risk and capital, together with business strategies centred on sound risk management practices, will enable insurers to achieve sustainable profitability whilst safeguarding policyholders' interests.

Under RBC, capital adequacy requirements are more granular and risk-sensitive compared to the previous solvency regime which did not differentiate between the nature and sources of risk. For example, insurers whose asset portfolios are concentrated in high-risk assets or assets that are inadequately matched with the corresponding liabilities will be required to hold more capital under RBC compared to the previous solvency regime. Similarly, insurers who underwrite volatile lines of business or are highly concentrated in a single line of business will be required to hold more capital than insurers with diversified portfolios of relatively stable lines of business. The new solvency measure is hence a better reflection of financial strength and has resulted in greater differentiation between insurers with varying risk profiles. The new capital adequacy requirements are also based on explicit capital charges for market, credit, insurance and operational risks, thereby enhancing transparency and improving insurers' ability to identify, measure and manage the risks inherent in the insurance business. This will enable insurers to respond to emerging risks in a more pre-emptive manner.

With the introduction of RBC, insurers with capital resources that are commensurate with their risk profiles will have higher Capital Adequacy Ratios (CAR), thus allowing for the more efficient deployment of any 'excess' capital towards value generating activities. A number of insurers with inadequate capital and exhibit low CAR under RBC have undertaken remedial actions, and are in the process of reducing the overall level of risk exposure or injecting additional capital. Throughout the parallel run, the Bank has required these insurers to submit capital management plans with specific milestones on strategies and action plans to improve their capital positions. These milestones and action plans are closely monitored to ensure an orderly transition to the RBC regime.

Chart 1
Capital Adequacy Positions of Insurers as at December 2008

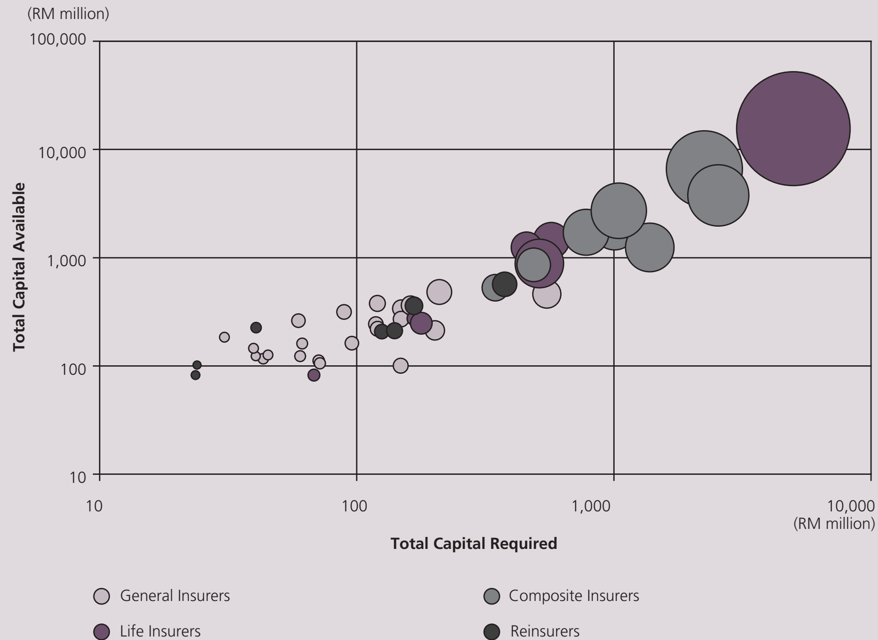

Chart 1 provides a snapshot of the current solvency levels in the industry by comparing the capital available against the capital required (All Funds) for insurers in the general, life, composite and reinsurance sectors, with the size of the bubbles denoting relative size by total assets. Life and composite insurers are typically larger, offer a wider range of products including complex products, and have greater exposure to market risk, hence the higher capital requirements.

To achieve its objectives, RBC is supported by a new set of valuation rules, requiring insurance liabilities and the related assets to be valued on a realistic basis, using market values or market value proxies, and which reflect the prevailing conditions in the business and economic environment.

The implicit margins that existed in the old valuation rules for insurance liabilities have been replaced with explicit margins for adverse deviations, which are now based on the actual experience of each individual insurer. For example, general insurers are now required to ensure that reserves are sufficient to meet expected claims based on the actual volatility of the claim patterns observed in the individual portfolios. Similarly, life insurers must hold reserves based on actual experience of mortality, morbidity, expenses, and persistency, instead of using a standardised mortality table with a fixed margin for prudence. In addition, insurers who underwrite innovative products with financial guarantees must hold additional reserves to ensure that those guarantees can be met even in adverse market conditions.

On the asset side, the introduction of market values has resulted in a more realistic balance sheet in accordance with the requirements of the relevant accounting standards. In response, many insurers have already taken the necessary steps to optimise asset portfolios according to risk appetite and expected return, while others are planning to make similar tactical shifts at the right market levels. Investment strategies are being rebalanced in response to prevailing market conditions and to improve the degree of matching between assets and liabilities. Portfolio changes during the parallel run have resulted in an increased level of assets of higher quality, which has served to support insurers well in the light of ongoing uncertainties in the capital markets.

The introduction of RBC has also provided the insurers' management teams with an additional quantitative tool to analyse and monitor the risks inherent in insurance activities. This shift of focus towards risk and its relationship with capital requirements has enhanced overall risk awareness and improved the quality of operational risk management and corporate governance. Many insurers are enhancing operations to improve their risk profiles, for example, by improving the quality of risk selection and underwriting, and by reducing volatility in loss experience through better claims management. Life insurers are also placing greater emphasis on product design and pricing, particularly to enhance the capital efficiency of their product range.

A survey of insurers also revealed positive changes to the intensity and breadth of oversight and discussion by Boards and Board Committees as a result of additional information arising from RBC. The same survey also revealed that many insurers are exploring other avenues to complement existing risk mitigants or increase available capital resources, such as reinsurance to transfer out excess insurance risks, derivatives to hedge asset-related risks or by the use of hybrid capital instruments.

Another positive development in the insurance industry arising from the introduction of RBC is the enhancement of insurers' technical expertise. The increased granularity and complexity of RBC computations have inevitably increased the demand for technical expertise, especially in the areas of realistic valuation of assets and liabilities, stress testing and the calculations for the various components within RBC. For example, insurers without access to in-house actuarial expertise have engaged external consultants to assist in the technical aspects of the RBC requirements. This is expected to further enhance insurers' technical competency through knowledge from such engagements. Furthermore, the increased proficiency of insurers in areas such as financial modelling will also support more effective risk management by enabling insurers to better anticipate emerging risks and to respond pre-emptively. Arising from the RBC requirements and the resulting increase in interaction with technical experts, insurers now recognise the need for developing such expertise internally or by obtaining the required support from group resources or external consultants.

The implementation of RBC is expected to further raise the overall level of resilience of Malaysian insurers, as the industry players continue to optimise their risk profiles and capital positions over the near future. The improvement in the quality and depth of statutory reporting brought on by RBC has also enhanced Bank Negara Malaysia's supervisory capabilities by providing an additional tool to identify problem areas early. Finally, the current market turmoil has also highlighted the need for a highly robust prudential framework that is supportive of strong capital adequacy, liquidity positions and risk management practices of insurers during periods of stress, while reducing the procyclical effects of regulation through economic cycles. To achieve this, the Bank is continuously reviewing and recalibrating the methodologies and parameters within RBC, to ensure that they remain relevant and appropriate at all times.

current issues in governance delivered by leading experts in their respective fields. Collectively, these channels support a continuous learning environment in which directors can receive regular updates and access information from a variety of resources on developments in governance practices and current issues in governance. A total of 180 directors of financial institutions will undergo FIDE training in 2009. In the short period since its launch, FIDE has also separately featured a number of notable speakers of international repute to address directors of financial institutions, with several more lined up throughout the year. Further information on FIDE can be obtained on its website at www.fide.org.my.

The Bank also finalised the revised standards on fit and proper requirements for boards and senior management of financial institutions. The revised requirements will clarify the Bank's expectations regarding institution's responsibilities to implement an ongoing internal process for assessing and confirming the suitability of individuals assigned to key functionary roles within the organisation. It also provides further elaboration on the fit and proper criteria that such individuals would be held to.

Risk management

Building on the various guidelines relating to risk management implemented for banking institutions and insurers, the Bank initiated an exercise to consolidate and rationalise these existing standards into a cohesive framework that would: (i) ensure consistent expectations and treatment of similar risks across business activities and financial sectors; (ii) enhance the clarity and logical structure of the regulatory framework; and (iii) promote greater convergence between, and the mutual reinforcement of, the regulatory framework and supervisory assessments. As part of this initiative, the Bank will undertake a comprehensive review and enhancement of its existing prudential guidelines and supervisory expectations relating to the key control functions that must exist and operate effectively within financial institutions in order to provide effective oversight of an institution's risk-taking activities. This encompasses the board and senior management, risk management, internal audit, compliance and management information system (MIS) functions. The resulting prudential framework will form the overarching guidelines and the foundation for the development of more specific guidance on the management of market, credit, liquidity, operational and insurance risks. The framework is intended to achieve a more consistent reflection of the Bank's approach to supervisory assessments of the risk profile of individual institutions, hence providing a common frame of reference for more constructive supervisory interactions with individual institutions on risk issues.

During the year, the Bank consulted the industry on standards relating to the risk management function, and issued guiding principles on data management and MIS frameworks. While varied practices and levels of sophistication have been observed in terms of approaches to structuring risk management functions by financial institutions, feedback received to the standards released by the Bank indicate a sharpened focus among financial institutions on the organisation of the risk management function and increased attention by the board and senior management in the oversight of risk management within institutions. This has been evidenced by the adoption of more formal governance structures and accountabilities for risk management activities within financial institutions. At the industry level, the associations of banks and insurers have also taken a more active role in promoting best risk management practices among industry members through dialogues and seminars organised on risk issues and developments. In the course of 2009, more specific guidance addressing the Bank's expectations in relation to the management of credit, market, operational and insurance risks will be issued for industry feedback.

The increasing intensity of liquidity pressures faced by financial institutions internationally towards the latter part of 2008 crystallised the Bank's own focus on planned enhancements to the Liquidity Framework imposed on the banking institutions. While liquidity was not a major concern domestically and a robust measurement framework for liquidity risk has been in place since 1998, accelerated efforts at the international level to establish sound liquidity risk management practices expedited the Bank's planned reforms to improve liquidity risk management practices within banking institutions. The proposed improvements will raise the baseline compliance requirements with respect to liquidity mismatches, and introduce more detailed guidance on sound liquidity risk management practices taking into account lessons

learnt from the crisis. Focus will also be given to addressing liquidity issues arising from the longer-term structural changes in the banking system, including the growing importance of Islamic banking and the emergence of financial groups which introduces additional complexities to the management of liquidity risk. This is discussed in further detail in the box article "Liquidity Risk Supervision and Challenges in Liquidity Risk Management".

Proposed improvements to the Liquidity Framework will raise the baseline compliance requirements with respect to liquidity mismatches, and introduce more detailed guidance on sound liquidity risk management practices

Financial reporting standards

In August 2008, Malaysia announced a policy of convergence with the IFRS by 2012. Such a policy is consistent with the Bank's own interests in improving the transparency and comparability of financial statements, thereby further enhancing market discipline over financial institutions. With the implementation of the RBC Framework for insurers on 1 January 2009, prudential standards on valuation were changed to adopt elements of FRS 139: Recognition and Measurement of Financial Instruments which will come into effect in Malaysia on 1 January 2010. Insurers therefore followed an earlier move by banks to partially pre-adopt the requirements of FRS 139. The Bank is in the process of finalising the remaining required changes to the prudential framework for banking institutions to achieve full alignment with FRS 139. These changes relate to standards for the impairment of loans and the application of the fair value option, which were areas reserved under existing prudential rules pending the development of the requisite capacity by banking institutions to ensure the integrity of the financial statements.

While convergence between financial reporting and prudential objectives is desirable, it is widely acknowledged that there will be some areas in which divergence may be inevitable. One such area which has drawn considerable international attention during this crisis relates to the adoption of counter-cyclical provisioning policies, supported by regulators for prudential reasons but restricted under financial reporting standards. Changes to the fair valuation of liabilities owing to a deterioration in an institution's own creditworthiness has also been contentious among the regulatory community which is concerned with the effects of the accounting value of liabilities being reduced and resulting gains being recognised by financial institutions. While the Bank generally supports the use of fair values to provide decision-useful financial information for key stakeholders of financial institutions, the financial turmoil underscores the importance of preconditions that must be met for the wider use of fair values to achieve this objective.

The financial turmoil underscores the importance of preconditions that must be met for the wider use of fair values

The preconditions include the development and continued existence of active markets for instruments which are marked-to-market and robust systems and procedures instituted within financial institutions to support sound analyses and the exercise of expert judgment by management regarding fair values. With regard to loan impairments specifically, the Bank will be issuing a set of supervisory expectations outlining key capabilities to be met by banking institutions before adopting FRS 139. These will address the effective oversight of the credit risk assessment process, loan loss identification as well as expectations concerning sound provisioning methodologies. Banking institutions would be required to undertake an internal assessment and demonstrate that they have met the specified expectations prior to the adoption of FRS 139.

Where the preconditions for the application of fair values are not adequately met, the Bank retains the ability to use prudential filters (regulatory prescriptions that do not change the current year financial results) to protect reserves and ensure that financial institutions remain sound. During the year, the Bank also held discussions with

various stakeholders in the financial reporting community to consider appropriate adjustments to the financial reporting framework to provide flexibility for the Bank to modify accounting standards applicable to financial institutions where necessary to preserve confidence in, and the integrity of, the financial system.

In response to the exceptional market conditions faced by banking institutions in the second half of 2008, the Bank allowed temporary flexibility for banking institutions to reclassify non-derivative financial assets out of the held-for-trading category from July 2008 until the end of 2009. This move was in line with similar changes announced by the International Accounting Standards Board and served to cushion the impact of extreme market movements which did not reflect the true underlying values of financial assets held by banking institutions. Similar flexibility was also granted to the insurance industry from 1 January 2009 until end-2009.

In August 2008, changes were also made to the operational requirements applicable to the restructuring and rescheduling of credit facilities to facilitate efforts by banking institutions to proactively manage and assist borrowers experiencing temporary financial strains. Specifically, regulatory processes and the parameters for the classification of rescheduled and restructured loans were simplified to facilitate the more efficient administration of these facilities by banking institutions. The flexibilities introduced were accompanied by strengthened expectations of the board of directors to develop clear and comprehensive policies on the classification and provisioning for rescheduled and restructured loans, and implement effective internal controls to avoid the 'ever-greening' of loans. These policies and controls are reviewed as part of the Bank's ongoing supervisory assessments.

Islamic finance and development financial institutions (DFIs)

During the year, the Bank intensified efforts to put in place a sound supporting regulatory framework for the international currency business activities of institutions licensed under the Malaysia International Islamic Financial Centre (MIFC) agenda to conduct international banking and takaful business. The regulatory framework governing these activities is broadly consistent with the main tenets of the prudential framework applicable to domestic business activities and establishes, among others, prudential standards and expectations in relation to capital adequacy, risk management, liquidity, single exposure limits, governance, and the offering of new products and services. It also elaborates the application of the risk-based supervisory framework (RBSF) to these institutions.

Regulatory efforts have also focused on strengthening the institutional resilience of DFIs to withstand shocks in this more challenging environment and to ensure they continue to be sustainable to meet their mandated roles. This has culminated in progressive improvements observed in the management and oversight of DFIs, most notably in the area of corporate governance. The boards of DFIs have been substantially strengthened to achieve a balanced mix of members with the necessary skill sets, expertise and experience to support more effective oversight, while management changes have provided stronger leadership to drive the execution of strategies and implementation of a clear policy framework that support the mandated roles of DFIs.

An important regulatory development during the year was the introduction of the Capital Framework for DFIs in February 2008. The framework appropriately supports the specific nature of DFIs' mandates and operations, while allowing DFIs to leverage prudently on their capital positions. This is reinforced by a specific requirement for DFIs to transfer a certain percentage of net profits to reserve funds when the risk-weighted capital ratio (RWCR) falls below a certain threshold specified by the Bank. In July 2008, approval was given for a DFI to participate in the interbank market, after fulfilling minimum requirements specified by the Bank. This will further enhance the role of DFIs in the economy by facilitating the more efficient management of liquidity and funding requirements.

SUPERVISORY ASSESSMENT

The Bank's supervisory activities in 2008 were substantially directed by unfolding events related to the global financial crisis. As conditions remained highly uncertain throughout the year, engagements with senior management and boards of financial institutions were intensified to monitor and assess developments affecting

individual institutions as well as the industry at large, and to communicate supervisory concerns in connection with the Bank's ongoing supervisory assessments and macro-surveillance activities. Close communications with chief executive officers, chief risk officers and heads of treasury of financial institutions, in particular, were maintained to obtain timely intelligence on market developments and how the institutions may be affected.

While the direct impact of the global financial turmoil on domestic financial institutions has been limited, the Bank maintained a heightened state of alert to the secondary effects of the financial crisis on the positions of financial institutions which had become more pronounced. This served to sharpen the focus of supervisory assessments during the year in specific areas, as outlined in Table 3.2.

Overall, risk exposures remained well-contained within the capacity of the financial system to absorb a further deterioration in global economic and financial conditions. Nonetheless, the severe impact and reach of the crisis renewed the Bank's focus on the prompt identification of emerging concerns within financial institutions. Significant attention was directed at improving the robustness of stress testing by financial institutions to incorporate scenarios under both plausible and extreme conditions.

Overall, risk exposures remained well contained within the capacity of the financial system to absorb a further deterioration in global economic and financial conditions

This was complemented by stress tests independently performed by the Bank to gauge the impact of calibrated shocks applied generally to the significant business activities of financial institutions, and more specific shocks applied to trading activities, off-balance sheet activities and liquidity positions. Identified vulnerabilities were discussed with the affected institutions and specific actions were taken, mainly through improvements to internal risk management practices, to shore up the resilience of these institutions. A detailed outcome of supervisory assessments is covered in the chapter "Risk Assessment of the Financial System".

Through its supervisory activities, the Bank has observed a general strengthening of risk management systems among licensed financial institutions. More specifically, there has been a heightened appreciation by the board and senior management of the primary risk drivers affecting their institution's risk profiles, thus supporting a more informed and proactive risk culture and more effective enterprise-wide risk management practices. This has translated into significant enhancements made in recent periods to the risk management capabilities of financial institutions through: (i) increased investments in more advanced credit assessment and portfolio management tools; (ii) better monitoring capabilities to support a more proactive approach to the management of problematic loans; (iii) improvements in risk management processes and structures for market and liquidity risk, and assessments and control of risk at a more granular level by independent risk management functions; and (iv) more proactive capital management by financial institutions in setting and maintaining internal capital levels that are well above the regulatory minimum, and in pursuing more efficient capital structures. Notable improvements observed in information flows and content have had an important role in driving this process.

Operational risk management practices have also seen substantial improvements. Noteworthy is a more pronounced move away from the silo management of operational risk focusing separately on fraud, data processing and IT security, towards greater integration of operational risk management strategies with firm-wide risk management systems and processes. More institutions have also acted to formalise governance and reporting structures for operational risk management functions, and increased related investments to develop the requisite expertise to support this function. This reflects an enhanced appreciation by the boards and senior management of the significance of operational risk, which has to date been largely overlooked among institutions relative to other risks. The increased focus on operational risk

Table 3.2
Specific Areas of Supervisory Focus

1. Credit Exposures	i) Significant lending portfolios of financial institutions such as retail, SME and corporate loans ii) Sectoral analysis (e.g. residential property, construction, energy and transportation sectors) iii) Counterparty risks of interbank lending and borrowing and reinsurance exposures iv) Exposures to borrowers in specific jurisdictions v) Large borrowers, restructured and rescheduled borrowers and watchlist accounts vi) Monitoring of loan growth and access to financing indicators
2. Market Risk	i) Equity market volatility monitoring with specific stress tests and scenario analysis conducted to assess impact under extreme case scenarios ii) Monitoring of foreign currency volatility against Malaysian ringgit and impact on institutional profitability iii) Monitoring of market volatility in debt securities market and impact on institutional holdings of debt securities
3. Liquidity	i) Monitoring of wholesale deposit profile and interbank activities to assess reliance on interbank markets, concentration of deposits and liquidity mismatches ii) Contingent liquidity exposures related to off-balance sheet activities iii) Monitoring of insurers' liquidity needs, arising from potential increases in surrenders
4. Capital Adequacy	i) Potential impact on capital from exposures to vulnerable economic sectors, deterioration in portfolio asset quality, earnings deterioration and losses from trading or mark-to-market exposures ii) Ability of institutions to redeem maturing instruments and replace/raise new capital in the current economic climate and potential costs involved iii) Potential capital support required from overseas operations iv) Robustness of internal capital adequacy ratios and capital management plans of insurers

has been further reinforced by the creation of a Technology Risk Specialist function to complement the Operational Risk Specialist function within the Bank to support more in-depth and integrated supervisory assessments of operational risk.

The implementation of PIDM's Differential Premium System (DPS) with effect from May 2008 further strengthened incentives for the adoption of sound risk management practices by banking institutions that are members of the deposit insurance system. Under the DPS, premium rates paid by member institutions are determined in reference to an assessment of the risk profile of the institution based on specified assessment criteria, which includes a substantial weightage accorded to the Bank's supervisory assessment of a banking institution. The operationalisation of the DPS has also promoted more rigorous exchange of information between PIDM and the Bank on the financial environment and institutional developments, thereby enriching both agencies' ongoing surveillance activities. These developments place Malaysia's financial institutions in a sound position to ride out the significantly more challenging environment that is expected to persist in 2009.

The global financial turmoil has brought to the forefront the importance of effective supervisory cooperation and coordination in averting threats to financial stability. The Bank has long supported this agenda, having established and continuously improved cooperative frameworks domestically with PIDM and the Securities Commission, and played an active role in spearheading regional cooperation arrangements through the Monetary and Financial Stability Committee of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and the South East Asian Central Banks (SEACEN). During the year, cross-border collaborative efforts were also extended bilaterally among the regional authorities to support the effective consolidated supervision of regionally active banks.

PRIORITIES MOVING FORWARD

To support the Bank's continued effectiveness in discharging its mandate for financial stability in light of the changing economic and financial landscape, significantly expanded provisions on financial stability were included in the proposed Central Bank of Malaysia Act. The scale and extent of global actions taken to contain the financial crisis have highlighted the critical importance of articulating a well-defined mandate for financial stability and legal framework for the prevention, management and resolution of financial crises.

Given the continuing stresses on the global financial system, and a widespread expectation of a sharp slowdown in global growth, the Bank's prudential regulatory and supervisory priorities will remain focused on four fronts. These are: (i) ensuring the effective functioning of the financial intermediation process which is critical to support growth during this challenging period; (ii) ensuring the Bank's and financial institutions' responsiveness to risks through ongoing enhancements to the prudential and legislative framework and heightened supervision; (iii) enhancing the use of both micro- and macro-level regulatory tools to lean against financial excesses and the build-up of systemic risks; and (iv) developing more robust systems and arrangements for detecting and addressing any emerging stresses in the financial system. A comprehensive and integrated plan for 2009 is now in place to support these priorities.

At the same time, the continuing evolution of the financial system in Malaysia will require commensurate attention to be devoted towards putting in place a sound regulatory framework to support the orderly growth of new financial activities and products. As these activities gather further momentum, the corresponding prudential focus and supervisory attention will have to increase proportionately to preserve the integrity and stability of the financial system. The Bank envisages work in this area to be primarily directed towards addressing the risks associated with new financial innovations while supporting the continuing development of sound governance and risk management practices within the financial sector.