Session 2
Improving supervisory intensity and effectiveness in dealing with SIFIs

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The Bank’s framework for financial stability

1. Effective Regulatory Framework
   - appropriate mix of principle and rule-based regulations
   - differentiated rules based on risk profile

2. Sound Supervisory Framework
   - risk-based and consolidated supervision
   - forward looking and preemptive
   - focus on corporate governance and risk management
   - collaboration with other supervisors

3. Comprehensive Surveillance Framework
   - macro and micro surveillance
   - scenario-based stress testing
   - ex-ante and forward looking

4. Robust Financial Infrastructure
   - payment system
   - consumer protection and education
   - legal framework
   - accounting standards

5. Effective Safety Nets & Crisis Management Framework
   - lender of last resort
   - deposit insurance
   - insurance benefits protection scheme
   - crisis resolution and management framework

6. Effective market discipline
   - consumer and shareholder activism
   - transparency and disclosure

The Bank’s framework for financial stability
Supervisory philosophy in the Bank

- Home-host regime
- National coordination

- Integrated macro- and micro-prudential analyses

- Effective collaboration and coordination

- Dynamic evolution

- Risk-based and consolidated

- Forward looking and preemptive

- Robust internal arrangements and resource management

- • Approach evolves according to changes in financial landscape and complexity of FI

- • Integrated and holistic

- • Supervisory judgment with appropriate check and balance
- • Resources vs risks/complexity

- • Intensity commensurate with degree of complexity
- • Interventionist (without micro-managing)

- • Early detection and corrective actions
- • Ongoing monitoring and re-assessments
- • Stress test and contingent planning
Evolving from rule-based to principle-based regulation

From detailed prescriptions and compliance regime...

Adapting to fundamental changes in financial landscape
- ↑ size, complexity and diversity of players
- Financial conglomeration and complex structures
- ↑ innovation and sophistication in products and services
- Significant growth of Islamic banking system
- ↑ market-based financing
- Regional expansion and integration
- ↑ cross-border linkages and contagion risks

...to high level principles which frame supervisory expectations

Bank’s focus on strengthening preconditions:
- Risk-based supervisory framework (SuRF – Supervisory Risk Framework)
- FIs readiness to implement principle-based regulation
- ↑ supervisory capacity – able to exercise sound judgment
- Engagement with Board/Senior Management on Bank’s supervisory/regulatory framework

- Preserve sound prudential framework at different stages of development of financial sector
- Ensure progressive shift in cognisance of state of FIs’ readiness
- Ensure regulation promotes productive innovation and responsible behaviour
- Ensure robustness against vagaries of changing market conditions

Slide 16 on FIDE
## Transitioning to consolidated, risk-based supervision

<table>
<thead>
<tr>
<th>Compliance-based approach</th>
<th>Risk-based (institutional focus)</th>
<th>Supervisory Risk Framework (SuRF)</th>
</tr>
</thead>
</table>
| • Full scope on-site examination  
  - Transaction testing and full verification  
• Point-in-time examination  
  - Rely on historical data with limited forward looking element  
• Institutional focus  
  • Separate off-site and on-site teams | • Focus on high risk areas  
  • Degree of transaction testing depends on quality of risk management  
• More forward-looking  
  • Peer benchmark (best practices)  
• By banking groups, incl.  
  • bank holding companies  
  • non-bank entities  
• Separate off-site and on-site surveillance team | • Focus on significant activities and risk management  
• Interventionist without micromanaging  
  • Continuous engagement with Board/Management  
• More focus on emerging risks and system wide interlinkages  
• Consolidated supervision and thematic based examination  
• Integrated surveillance by same team (on and off-site) |

**More risk-based thematic examinations**

**Relationship managers, risk specialists and portfolio experts**

**Increase engagement with Board, FIs and other regulators**
Setting the “forward looking and interventionist” culture
- *Low tolerance for unanticipated “amber” FIs*

### The Bank’s Financial Stability Functions
- Regulate and supervise financial institutions which are subject to the laws enforced by the Bank
- Promote a sound, progressive and inclusive financial system;
- Exercise oversight over payment system

### Key Performance Indicators
- Accurate, early detection of risks & vulnerabilities
- Timely & effective supervisory actions to address vulnerabilities

### No unanticipated amber FIs

### Strategies
- Strengthen supervisory processes & infrastructures

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**Category of FIs**
*(based on Composite Risk Rating and Supervisory Intervention Guide)*

- **Green**
- **Amber**
- **Red**
The Bank deploys various preventive and intervention measures

- Annual business strategy review to assess strategic direction, changes in risk appetite/profile
- Readiness assessment for subsidiaries and overseas expansion
  - capacity, risk management and infrastructure
- Quarterly stress test to assess resilience to shocks
- Supervisory approval for
  - new products
  - dividend payments
- Set minimum composition of independent directors
- Non-renewal for re-appointments of “non-performing/ineffective” directors’, CEOs, auditors

- Contingency planning
- Business restrictions
  - by business segments, products or investments
- Reconstitute Board or replace weak management
- Require capital/liquidity commitments from shareholders/parent
Implementing the “forward looking and interventionist” approach - An example

<table>
<thead>
<tr>
<th>Profile of Bank A</th>
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</thead>
<tbody>
<tr>
<td>Composite Risk Rating (CRR) = MODERATE</td>
</tr>
<tr>
<td>Significant Activities and Inherent Risks</td>
</tr>
<tr>
<td>MODERATE</td>
</tr>
<tr>
<td>• Aggressive expansion in retail lending (particularly housing/personal loans)</td>
</tr>
<tr>
<td>– Underwriting standards weakened (higher overrides)</td>
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<tr>
<td>– Contributed 10% to total increase in HH debt</td>
</tr>
<tr>
<td>• Early signs of weaknesses in corporate lending portfolio</td>
</tr>
<tr>
<td>• Increase in treasury related activities (structured products and derivatives)</td>
</tr>
<tr>
<td>Risk Management (RM), Controls and Oversight</td>
</tr>
<tr>
<td>• WEAK Board oversight</td>
</tr>
<tr>
<td>– Faction in Board</td>
</tr>
<tr>
<td>• MARGINAL RM (remains status quo)</td>
</tr>
<tr>
<td>– Underpricing of risks for some loan segments</td>
</tr>
<tr>
<td>– Lack of expertise, flawed risk models (not through-the-cycle)</td>
</tr>
<tr>
<td>Capital and Earnings</td>
</tr>
<tr>
<td>MARGINAL</td>
</tr>
<tr>
<td>• Buffers only cover potential losses under Scenario 1</td>
</tr>
<tr>
<td>Direction of risk (1-year)</td>
</tr>
<tr>
<td>INCREASING</td>
</tr>
<tr>
<td>• Stress test indicates large losses under Scenario 2 (corporate lending and</td>
</tr>
<tr>
<td>housing loan portfolio)</td>
</tr>
<tr>
<td>Supervisory Staging</td>
</tr>
<tr>
<td>POTENTIAL “AMBER”</td>
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**Series of early intervention by supervisors**
- Non-approval of structured products until related-risk management is enhanced
- Require bank to outline capital plan if stress scenario materialises
- Require higher provision for housing loan portfolio
- Restriction on dividends unless capital plan is reviewed or obtained capital commitment from shareholders
- Reconstitute Board and increase no. of independent directors
- Restrict further acquisition/regional expansion unless capital strengthens

**Complemented by other policy responses**
- Introduce Financial & Debt Management Prog.
- Guidelines on (1) responsible lending; and (2) sound risk pricing practices
Challenges to the Bank’s approach
- Managing supervisory judgment, check and balance, trade-offs

- Judgement-based approach supported by strong check and balance
  - Focus on qualitative assessment and ongoing engagement with Board/Management
    ▪ Rely on intimate knowledge of business and people
    ▪ Challenge robustness of business strategy formulation and risk management models/policy
    ▪ Industry best practice benchmark
  - Quantitative/model-based assessment to validate/complement judgement
  - Independent review and ensure consistent practices/ratings
    ▪ Ratings Panels (2 levels) consisting members outside of the Supervision Department
    ▪ Supervisory Practices Unit

- Managing trade-offs (regulatory burden vs innovation/growth)
  - Enhanced internal arrangements, governance and decision making process
    ▪ Financial Stability Sector reorganised by functional lines with clear accountabilities
    ▪ Committee-based decision making to manage trade-offs effectively
  - Greater emphasis on
    ▪ building sustainable business models
    ▪ positive risk culture and governance to ensure prudent risk-taking
    ▪ cultivating responsible behaviour and commitment to fair consumer practices
Optimising scarce resources and ongoing capacity building

Key determinants of the scope, depth and frequency of supervisory activities

- Board effectiveness
- Risk management capacity
- Inter-connectivity
- Complexity
- Risk profile
- Size

Institutional risks, complexity and contribution to systemic risks

Ensuring efficient & optimal allocation
- Resources organised along functional lines, with continuous consultation & collaboration with
  - Supervisory Practices Unit
    - ensure consistency of practices
  - Risk specialists and technical groups
    - e.g. conduct industry-wide thematic studies and horizontal analysis
  - Financial Surveillance Department
    - integrate macroprudential analysis (e.g. structural vulnerabilities, contagion and systemic impact)

Ongoing capacity building
- Cross-departmental placements and exchange of expertise
- Attachment programme with industry
- Progressive internal training programmes (Basic, Intermediate, Advanced)
  - Banking/Insurance Supervision Course
  - Bank Management Programme
  - Central Banking Course
Effective coordination with deposit insurer (PIDM) and Securities Commission (co-regulator)

Agreement to ensure effective collaboration and coordination to achieve financial stability, including intervention and resolution of member FIs

Category of FIs – based on Composite Risk Rating and Supervisory Intervention Guide

- Green
  - Category 1
    - Supervisory assessment
    - Interventions

- Amber
  - Category 2
  - Categories defined by Bank

- Red
  - Categories defined by Bank
  - Bank invokes non-viability trigger
  - PIDM to seek least cost resolution

Where institution is non-viable or likely to be non-viable

- BNM invokes non-viability trigger
- PIDM to seek least cost resolution, in consultation with the Bank

Memorandum of Understanding

Collaboration and coordination in (1) development of policies; (2) information exchange; (3) managing threats to stability; (4) regulation, supervision and resolution of investment banks; and (5) joint-investigations
Comprehensive powers to address systemic risk and FIs
- *Within and outside of Bank’s regulatory perimeter*

**Central Bank of Malaysia Act 2009**

**Ex-ante surveillance powers for timely risk identification**
- Access to information either directly or indirectly via relevant authorities

**Power to enter into arrangements, advice and make recommendations to other supervisory authorities**
- Co-operate and coordinate financial stability measures
- Promote laws & policies that are consistent with financial stability

**Pre-emptive powers to avert or mitigate systemic risks**
- Order to undertake corrective measures for the purpose of financial stability
- Liquidity assistance
- Capital support

**Ex-post powers to minimise impact of instability**
- Order for compulsory transfers (part or whole of business, shares, assets and liabilities)
- Bridge institution
Clear, preemptive triggers for exercise of financial stability powers

In the opinion of the Bank

Risk to financial stability

- Disrupts or is likely to disrupt
  - Financial intermediation process

- Disrupts or is likely to disrupt
  - Orderly functioning of the money and FX markets

- Affects or is likely to affect
  - Public confidence in the financial system
    - Stability of the financial system
Supported by enhanced institutional framework and governance

**Financial Stability Executive Committee**

- High level committee established under s.37 of CBA 2009 to review and decide on the Bank’s recommendations to manage risks to financial stability
  - Entities outside regulatory perimeter of the Bank
  - Involves public funds

**Recommendations with systemic implications**

**Joint meeting for effective deliberation and consideration of macroprudential measures to safeguard financial and macroeconomic stability**

**Financial Stability Policy Committee (within the Bank)**

- Risk assessment
- Macroprudential responses
- Microprudential responses
- Supervisory interventions
- Monitor implementation of approved actions by Executive Committee
- Trigger resolution by PIDM

**Monetary Policy Committee (within the Bank)**

- Maintaining price stability while giving due regard to the developments in the economy
- Formulation of monetary policy and policies for the conduct of monetary policy operations

**Resolution of individual FI by PIDM**
Thank you
Continuous development of high impact Boards
- Financial FIs Directors’ Education Programme (FIDE)

Launched in 2008 by the Bank and PIDM (Malaysia Deposit Insurance Corporation) to strengthen board governance effectiveness to drive long term sustainability of financial FIs (FIs)

**Objectives**

1. Strengthen skills and knowledge of Directors
2. Strengthen FI Directors’ ability to provide strategic direction & effective oversight
   - Incl. risk management and internal control
3. Provide understanding of current issues and developments in the FI sector
4. Create an on-going learning environment for Directors of FIs
5. Build a pool of potential FI Directors

**Comprehensive coverage**

1. Core programme, covering inter alia
   - enterprise-wide risk management, risk analysis, capital management strategies, stress testing and scenario planning
2. Technical programmes e.g.
   - Risk management in Islamic finance
3. Specialised programmes e.g.
   - Board Audit Committee
   - Board Risk Management
   - IT Governance and Risk Management
Functional organisational structure based on components of financial stability framework

**Macro-surveillance**
- Financial Surveillance
  - Macro-prudential analysis
    - Financial/non-financial sectors
    - Financial markets
    - Non BNM regulated entities
  - Crisis management arrangements

**Micro-Surveillance**
- Financial Conglomerate Supervision
  - Conglomerate Banking Group
- Banking Supervision
  - Foreign Banks
  - Stand alone Islamic Banks
  - Stand alone Investment Banks
  - Development Finance FIs
- Insurance & Takaful Supervision
  - Life, General
  - Takaful
  - Reinsurers

**Regulation**
- Prudential Financial Policy
- Consumer & Market Conduct
- Payments System Policy

**Supervisory Practices Unit**
- Ensure consistency of supervisory practices
- Provide guidance and support on RBSF

**Risk Specialists : Credit, Market, Operational, Technology, Actuarial**
- Provide technical advice and support to line departments
- Conduct horizontal risk assessment and on risk practices