



Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

**RESPONSE TO THE CONSULTATION PAPER ON
CRITERIA FOR QUALIFIED THIRD PARTY**

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1.0 INTRODUCTION

1.1 On 26 August 2011, Perbadanan Insurans Deposit Malaysia (“PIDM”) issued a Consultation Paper on Criteria for Qualified Third Party (“CP”). Written comments were invited from interested parties on the proposals made in the CP, in particular, for the following three (3) areas:

- (a) in respect of the proposed criteria for a qualified third party (“QTP”) in relation to member institutions (“MIs”);
- (b) in respect of how the proposed criterion for QTP in relation to Affected Persons (“APs”) could be further defined given the diverse nature of the qualified financial agreements (“QFAs”) that APs may be exposed to; and
- (c) the scope of agreements of the MIs and APs that are subject to the potential transfer to a QTP.

At the close of the consultation period, written comments were received from 16 deposit-taking members, 10 insurer members, the International Swaps and Derivatives Association, Inc. (“ISDA”), Bank Negara Malaysia (“BNM”) and the Securities Commission Malaysia.

1.2 PIDM wishes to thank the respondents for their constructive and useful comments on the CP. PIDM has carefully considered these comments and our response to the comments are set out in the next section. Given the significant overlap in the comments received, we have grouped the comments under broad topics and provided our responses on that basis.

2.0 SUMMARY OF COMMENTS AND PIDM’S RESPONSES

In respect of the proposed criteria for QTP in relation to MIs

2.1 Section 6.1 of the CP had proposed three (3) criteria for a QTP for the purpose of transferring QFAs from a failing MI. The transfer of the QFAs may be undertaken by PIDM as part of PIDM’s resolution of the failing MI. PIDM’s primary objective in implementing the transfer of QFAs to the identified QTP is to mitigate systemic disruptions that could be caused by the mass termination of the QFAs and to maintain stability of the financial system.

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- 2.2 The details of the criteria, the comments received, and PIDM’s responses, are set out below.

Criterion 1:

“An institution licensed under the Banking And Financial Institutions Act 1989, the Islamic Banking Act 1983, the Insurance Act 1996, the Takaful Act 1984 or the Development Financial Institutions Act 2002.”

The rationale for this criterion, as stated in paragraph 6.2(a) of the CP, was as follows:

“PIDM envisages that QFAs that have been entered into by the failing MI may be packaged together with the sale of the MI’s other assets and liabilities during the resolution process. Licensed institutions are likely to be a category of candidates interested to acquire assets and liabilities (including QFAs) of failing institutions. A licensed institution for this purpose would include an existing licensed institution or an entity which BNM would admit as a licensed institution.”

Comment 1: QTP to be a similarly situated institution

Most respondents recognised the need for PIDM to be able to transfer QFAs to a QTP upon failure of an MI and did not raise any specific objection to the institutions listed under criterion 1 above.

Many respondents however, wanted clarification as to whether the criterion would allow PIDM to transfer QFAs from a bank to an insurance company, or vice versa. A view that was advocated by some respondents was that the QTP should be an institution that is similarly situated as the failing MI i.e., bank for bank, insurance company for insurance company, Islamic institution for Islamic institution, and conventional institution for conventional institution. Further, respondents also highlighted that under BNM’s *Revised Guidelines on Derivatives for Insurers* (“BNM’s Guidelines”), insurer members are only allowed to engage in derivatives activities for hedging purpose only. As such, transfer of QFAs without its underlying hedged positions to insurance companies or takaful operators during resolution would be in breach of BNM’s Guidelines.

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PIDM's Response:

The criterion is aimed to cater for the transfer of QFAs from PIDM's deposit-taking members and insurer members.

Whilst most transfers would take place between similarly situated institutions, we do not discount the possibility that there may be instances (although perceived to be rare) when QFAs may be transferred across institutions that are not similarly situated. For example, a bank may acquire certain assets of a failing insurance company together with the QFAs that hedge those assets.

In identifying the QTP, PIDM will take into account the relevant requirements under the various legislation, regulations and guidelines governing both the non-defaulting counterparty and the QTP to ensure compliance with the same.

Comment 2: Criteria for QTP to provide assurance on the viability and ability of the QTP to continue with the QFAs

Several respondents suggested that the criteria for QTP should provide some form of assurance regarding the capacity of the QTP to assume the QFAs (for example, financial capability, credit standing and legal capacity) as well as on capability of the QTP to continue with the QFAs it assumes (for example, expertise and operational capability or infrastructure).

PIDM's Response:

Whilst PIDM takes note of the suggestion by respondents for the inclusion of such assurances as part of the criteria for QTP and recognises the need to provide some form of assurances, PIDM is also of the view that a criterion should be objective and unambiguous to facilitate effective implementation.

Whilst the additional criteria, for example, financial capability, credit standing, knowledge and expertise, and operational capability or infrastructure, as proposed by the respondents may give some comfort to non-defaulting counterparties, they are subjective in nature and may result in differing interpretations by affected parties.

Taking the industry's comments for inclusion of some assurances into consideration, PIDM will include the phrase "**which is in compliance with capital and prudential requirements of Bank Negara Malaysia**" at the end of the criterion. This is in line with the proposal made by the Financial Stability Board in Annex 8 of its Consultative Document titled "Effective Resolution of Systemically Important Financial Institutions" issued on 19 July 2011 which states that:

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*“In the case of a transfer to a bridge financial institution or other specialized entity that is not required to be capitalized under the applicable legal framework or that does not have a credit rating, some form of assurance may be needed... **If the acquiring entity is a healthy institution that is fully capitalized and in compliance with prudential requirements**, assurances of performance should not be necessary, especially since the counterparties’ rights to terminate based upon a breach of the contract by the acquirer [QTP] would be enforceable.”*

In determining the legal capacity of the QTP, PIDM will require the QTP to provide the necessary representation on its legal capacity to enter into such transactions in accordance with normal market practice.

Criterion 2:

“A foreign financial institution.”

The rationale for this criterion, as stated in paragraph 6.2(b) of the CP, was as follows:

“This criterion will allow PIDM to transfer QFAs, for example, non-Malaysian Ringgit denominated derivatives, to foreign financial institutions that do not have licensed operations in Malaysia, in the event that such transfer is deemed appropriate to avert an adverse impact to the stability of the Malaysian financial system.”

Comment 3: Definition of a “foreign financial institution”

Based on the comments received, PIDM observes that the industry is generally concerned about allowing a foreign financial institution, which is not subject to BNM’s regulatory and supervisory standard, to be a potential QTP. Some respondents proposed that the criterion be refined, for example, by requiring the foreign financial institution to be an institution licensed under its home jurisdiction and by providing assurance that the foreign financial institution is viable and will be able to continue to perform the QFAs.

Respondents had also pointed out some of the practical difficulties in transferring QFAs to a foreign financial institution. For example, the ability to transfer the QFAs to a foreign financial institution that is in a jurisdiction other than Malaysia within the temporary suspension period (currently proposed to be 10 days) and in relation to the enforceability of the QFAs.

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The insurer members on the other hand, have highlighted that under BNM's Guidelines, insurer members are only allowed to deal with eligible counterparties, which comprise banking institutions licensed under the Banking And Financial Institutions Act 1989 ("BAFIA"), the Islamic Banking Act 1983 ("IBA"), the Capital Market Services Act 2007 licensees authorised to conduct dealing or trading in derivative contracts and regulated local and foreign exchanges (for exchange-traded derivatives). As such, they are concerned that the transfer of QFAs to a foreign financial institution that is not an eligible counterparty would cause the insurer members to be in breach of BNM's Guidelines.

PIDM's Response:

Taking into account the comments from the industry, PIDM has defined the types of institution under this category that qualify as a QTP to be:

"an institution licensed under the Labuan Financial Services and Securities Act 2010 or the Labuan Islamic Financial Services and Securities Act 2010, which is in compliance with capital and prudential requirements of the Labuan Financial Services Authority."

In identifying the QTP, PIDM will take into account the relevant requirements under the various legislation, regulations and guidelines governing the non-defaulting counterparty and the QTP to ensure compliance with the same.

Criterion 3:

"A public entity or an entity which the Government of Malaysia or PIDM has provided guarantees for the performance of the qualified financial agreements."

The rationale for this criterion, as stated in paragraph 6.2(c) of the CP, was as follows:

"This criterion is to cater for the situation where the QFAs need to be transferred in order to avert an adverse impact to the Malaysian financial system caused by the unwinding of the QFAs of the failing MI.

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A transfer to a public entity is in line with the recommendation of the BIS report¹, which states that *“national resolution authorities should have the legal authority to temporarily delay immediate operation of contractual early termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution, a bridge financial institution or other public entity”*.

The criterion also caters for the transfer to an entity that the Government of Malaysia or PIDM has provided guarantees for the performance of the QFAs – this may include an asset management company assuming the operating assets of the failing MI together with the QFAs that hedge these assets.”

Comment 4: Definition of “public entity”

Generally, the respondents did not raise any objection regarding the proposal for PIDM to be able to transfer QFAs to a “public entity”. However, respondents had concerns that the term “public entity” may have to be defined as it is not a term that has been defined in any statute in Malaysia. There was also a proposal that a “public entity” be an entity which does not enjoy any sovereign immunity.

PIDM’s Response:

PIDM acknowledges that the term “public entity” needs to be defined to provide clarity and as such, has taken guidance from the definition of “public sector entity” in BNM’s *Risk Weighted Capital Adequacy Framework (Risk-Weighted Assets Computation – Basel II)*. Accordingly, PIDM has defined a “public entity” as an entity established under its own Act. Generally, statutory bodies in Malaysia are not immune from legal actions being taken against them for breach of contractual obligations and PIDM is of the view that “sovereign immunity” is not the appropriate term to use in this context.

Comment 5: Guarantees for the performance of the QFAs v guarantees for the QTP as an entity

There was a comment that the guarantee to be provided should be a legally enforceable “all-moneys” guarantee that would not be subject to any sovereign immunity. Also, respondents commented that the guarantee provided should extend to all the obligations of the QTP, otherwise the assurance on the continued viability of the QTP would be undermined. The justification for the comment was that although the non-defaulting counterparty has recourse from the guarantee provided by the Government of Malaysia or PIDM for the performance of the QFAs, the enforcement of the guarantee would likely incur costs and time.

¹ Bank for International Settlements’ final report titled “Report and Recommendations of the Cross-border Bank Resolution Group” issued in March 2010

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PIDM's Response:

Guarantees will likely only be given in respect of existing outstanding transactions/trades under the QFAs that have been transferred. The guarantee will cover the performance of the outstanding transactions/trades until the termination or maturity of those transferred transactions/trades, or until the transactions/trades are renegotiated by the parties, whichever is earlier. PIDM is unlikely to provide a guarantee on the continued viability of the QTP as PIDM has no control over any undertaking beyond the transferred transaction/trades under the QFAs. Further, in the unlikely event of the failure of the QTP subsequent to the transfer, the non-defaulting counterparty will have recourse from the guarantee provided by the Government or PIDM for the performance of the transferred transaction/trades under the QFAs. In addition, the non-defaulting counterparty preserves its rights to terminate the contract as per the terms and conditions of the agreement after the transfer.

In addition, PIDM will be including **BNM-guaranteed entities** as potential QTPs given that BNM also has powers to provide guarantees under subparagraph 32(1)(c)(ii) of the Central Bank of Malaysia Act 2009.

In respect of how the proposed criterion for QTP in relation to APs could be further defined given the diverse nature of the QFAs that APs may be exposed to

- 2.2 In relation to AP, paragraph 6.3 of the CP had proposed the following criterion for a QTP:

Criterion:

“Any party who is willing to assume the qualified financial agreements of the Affected Person would be eligible to do so.”

The rationale for this criterion, as stated in paragraph 6.4 of the CP, was as follows:

“The rationale for the proposed criterion is that the type of QFAs entered into by APs can be very diverse depending on the nature of the business that the APs are involved in.”

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Comment 6: Selection criteria for QTP in relation to APs

Generally, the respondents were of the view that the criterion is too wide, and there has to be some form of assurance that the QTP is viable and would be able to continue to perform the QFAs. Several suggestions were given on how the criterion could be further defined. For example:

- Restricting the QTP to a public or private company as that defined under the Companies Act 1965;
- Requiring the QTP to possess the relevant financial capability, knowledge and expertise and operational capability or infrastructure;
- Requiring the QTP to be located in the same jurisdiction and be subject to the same governing law as the failing MI;
- Requiring the QTP to assume the QFAs as bona fide transactions for its own account and not merely as an advisor;
- Requiring the QTP to not be connected to the failing AP;
- Requiring the QTP to be in compliance with applicable Malaysian rules and laws; and
- Requiring the QTP to meet the criteria under Capital Market and Services (Amendment) Act 2011 for non-foreign exchange OTC derivatives transactions.

PIDM's Response:

Within the context of the Malaysia Deposit Insurance Corporation Act 2011 ("PIDM Act"), APs may include investment banks as well as non-bank entities that undertake derivatives positions, for example, commercial borrowers of the failing MI. As such, in proposing the criterion, PIDM had drafted the criterion widely in order to cater for transfers of QFAs from APs operating in different industry sectors and that may enter into an array of standardised and non-standardised derivative contracts, for example, commodity derivatives, weather derivatives etc., depending on the nature of their businesses.

PIDM is of the view that criteria such as requiring the QTP to possess the relevant financial capability, knowledge and expertise, and operational capability or infrastructure are subjective in nature and may be subject to differing interpretations when implemented. Similar to the criteria for QTPs in relation to transfer of QFAs from MIs, PIDM is of the view that the criteria should be objective and unambiguous in nature.

However, taking into account the industry's comments for some form of assurances on a QTP, PIDM has adopted the same QTP criteria for the transfer from APs as those for the transfer from MI.

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The scope of agreements that are subject to the potential transfer to a QTP

Comment 7: General comments
<p>Generally, respondents did not provide a view on the scope of agreements that are subject to the potential transfer to a QTP as provided under subsection 115(1) of the PIDM Act.</p> <p>There were however, several respondents who sought clarification on whether the scope of the QFAs could be broadened to include other types of agreements such as treaty reinsurance agreements and retrocession agreements.</p>
PIDM's Response:
<p>Treaty reinsurance agreements, retrocession agreements and other insurance agreements do not fall under any of the types of QFAs currently set out under subsection 115(1) of the PIDM Act. We recognise that while these agreements are similar to derivatives (which are QFAs), they are tools used to hedge against certain risks and their nature is not the same as derivatives because:</p> <ul style="list-style-type: none"> (i) the obligation and quantum involved under such an agreement is not derived from, referenced to, or based on certain reference item or index, but are on indemnity basis; and (ii) insurance and reinsurance contracts cannot be transacted, but are tied to insurable interests which are personal to the insured.

3.0 CLARIFICATION IN RELATION TO THE IMPLEMENTATION OF THE TRANSFER

Comment 8: Operational aspects of the transfer to QTP
<p>Several respondents had raised questions in relation to several operational aspects of the transfer of QFAs to a QTP as follows:</p> <ul style="list-style-type: none"> (i) the transfer process; (ii) effects of the transfer on existing terms and conditions of the QFA; and (iii) transfer costs.
PIDM's Response:
<p>Although not directly relevant to the criteria of the QTP, PIDM is of the view that the questions raised by the respondents merit some explanation to help the industry better understand the mechanics of the transfer of QFAs to a QTP.</p> <ul style="list-style-type: none"> (i) Transfer process <ul style="list-style-type: none"> • PIDM will evaluate the outstanding contracts of the failing MI/AP in respect of each counterparty. In its evaluation, PIDM will consider factors

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such as the potential impact to the stability of the financial system if the QFAs were to be terminated, the potential loss to be incurred by the parties, and such other factors it deems appropriate.

- In the event that a transfer to a QTP is found to be appropriate, PIDM will identify a potential QTP based on the criteria set out. Any transfer of QFAs to a QTP will be on a willing buyer-willing seller basis. It follows that the cost of transfer of the QFAs, and the terms and conditions of the transfer will be negotiated between the Appointed Person/Receiver (in the case of an MI) or Conservator (in the case on an AP), and the QTP.
- PIDM will adhere to the “no cherry picking rule” in effecting the transfers to a QTP.
- The transfer of QFAs may be effected via a transfer instrument in accordance with the Second Schedule of the PIDM Act and will be binding on any person thereby affected.
- PIDM shall notify the counterparties as soon as practicable upon effecting transfer of the QFAs to the QTP.

(ii) Effects of the transfer on existing terms and conditions of the QFAs

- There will be no change to the terms and conditions of the QFAs as a result of the transfer to a QTP. The QTP assumes all rights and obligations (including all security and margin requirements/obligations) of the failing MI/AP as provided under the QFAs that have been transferred to the QTP.
- Any amount falling due/maturing on outstanding QFAs during the 10-day temporary suspension period will be honored in accordance with the terms of the agreement between the failing MI/AP and the counterparty.
- Termination rights of counterparties after the transfer are preserved. In the event that there is any breach of terms and conditions after the QFAs have been transferred to a QTP, parties may exercise their rights to terminate the contract or seek any other redress according to the terms and conditions of the contract.

(iii) Transfer costs

- All transfer costs will be borne by the Appointed Person/Receiver/Conservator and can be claimed against the assets of the failing MI/AP. Hence, it is envisaged that there would be no transfer costs imposed on non-defaulting counterparties.



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4.0 REVISED CRITERIA FOR QUALIFIED THIRD PARTY

4.1 Based on the comments received from the consultation process and PIDM's responses, PIDM has revised the criteria for the QTP for MIs and APs as follows:

- (a) an institution, other than a bridge institution², licensed under the BAFIA, the IBA, the Insurance Act 1996 and the Takaful Act 1984 or an institution prescribed under the Development Financial Institutions Act 2002, which is in compliance with the capital and prudential requirements of BNM;
- (b) an institution licensed under the Labuan Financial Services and Securities Act 2010 and the Labuan Islamic Financial Services and Securities Act 2010, which is in compliance with capital and prudential requirements of the Labuan Financial Services Authority;
- (c) a public entity established under its own statutory act; or
- (d) an entity whose obligations under the QFAs are guaranteed by the Government of Malaysia, BNM or PIDM.

4.2 The criteria above are not listed in any order of priority.

5.0 GOING FORWARD

The revised criteria have been set out in a draft Order which will be forwarded to the Treasury Solicitor and the Attorney General's Chambers as part of the legislative process. As part of this process, there may be amendments or refinements made to the draft Order. The public will be informed through the Gazette and PIDM's website once the Order comes into force.

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² The power to transfer QFAs to a bridge institution is separately provided for under section 115(3) of the PIDM Act.