



Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

**RESPONSE TO THE CONSULTATION PAPER ON
PROPOSED AMENDMENTS TO
THE MALAYSIA DEPOSIT INSURANCE CORPORATION
ACT 2005 AFFECTING CERTAIN
FINANCIAL TRANSACTIONS**

ISSUE DATE : 29 MARCH 2011



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Ref No	DI/CP10-R/2011	Issued on	29 March 2011
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BACKGROUND

On 30 June 2010, Perbadanan Insurans Deposit Malaysia (“PIDM”) issued a Consultation Paper on Proposed Amendments to the Malaysia Deposit Insurance Corporation Act 2005 Affecting Certain Financial Transactions (“Consultation Paper”) to interested parties. Written comments were invited from interested parties on the issues raised in the Consultation Paper. At the close of the consultation, written comments were received from deposit-taking members and the International Swaps and Derivatives Association, Inc. (“ISDA”).

Subsequently, the Malaysia Deposit Insurance Corporation Act 2005 (“PIDM Act 2005”) was repealed by the Malaysia Deposit Insurance Corporation Act 2011 (“PIDM Act 2011”), which was passed by Parliament in December 2010. The PIDM Act 2011 was gazetted on 27 January 2011 and came into operation retrospectively on 31 December 2010. The proposed amendments were incorporated into the PIDM Act 2011, taking into consideration responses to the Consultation Paper.

PIDM wishes to thank the respondents for their written comments on the Consultation Paper. The written comments on the Consultation Paper have been given due consideration and PIDM’s response is as follows.

A. IN RESPECT OF PARAGRAPH 3 OF THE CONSULTATION PAPER, UNDER THE HEADING “PROPOSED AMENDMENTS IN RELATION TO MEMBER INSTITUTIONS”

1. PROPOSAL TO AMEND SECTION 80 – QUALIFIED FINANCIAL TRANSACTIONS
3.2.2 PIDM proposes that drafting changes be made in the Act in the description of the qualified financial transactions to make it clear what types of derivatives and collateral agreements are excluded from the application of section 76 of the Act. This would ensure that the transactions described in section 80 do not inadvertently include other agreements, such as supply agreements, which are not intended to be excluded from the application of section 76. The proposed drafting will be in line with legislative provisions drafted in other jurisdictions, such as Canada, with a similar objective.

Comments Received
The main concern of some of the respondents was that the wording of the list of derivatives does not clearly reflect Shariah-compliant derivatives.



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PIDM's Response

Section 115 of the PIDM Act 2011 provides for the description of "qualified financial agreements" and the definition of "derivative", so as to make clear the types of derivatives and collateral agreements that are excluded from the application of the stay provisions (now in section 109). The description and definition are drafted in manner so as to include Shariah-compliant derivatives.

2. PROPOSAL TO ALLOW TEMPORARY DELAY IN THE OPERATION OF CLOSE-OUT NETTING PROVISIONS

3.3.7 PIDM proposes a temporary delay of ten (10) days, following which the counterparty may exercise its rights to terminate the transactions, if PIDM does not determine that a transfer should take place within that period of time.

Comments Received

Some of the respondents indicated that they disagreed with the imposition of the temporary delay of 10 days. Their view was that any temporary delay should be kept as short as possible in order to balance the goal of providing the regulator with the flexibility to exercise transfer rights while also balancing the market need for prompt close-out so as to alleviate the risk of market movement during the period of the stay.

PIDM's Response

The primary objective of the proposed power of suspension is to allow regulators to achieve the orderly unwinding of an institution's large derivatives positions. In other words, it is to allow regulators to prevent a situation whereby the unwinding of an institution's derivatives portfolio (precipitated by counterparties) could have a significant distorting impact on market prices and cause the ceasing up of markets, or produce large losses for a number of creditors and counterparties.

PIDM maintains its position, for the time being, that the proposed 10-day period is needed. This is because PIDM could be in a position where it would not have sufficient information concerning the qualified financial agreements (QFAs) when it assumes control of a member institution ("MI"). PIDM would therefore need time to identify the QFAs entered into by the MI, analyse them and determine if they should be transferred out.

Having said that, the period of the temporary delay will be provided for in regulations, instead of the primary Act. This will allow greater flexibility for PIDM to reduce the number of days, when PIDM is satisfied that it would be able to access the necessary information easily. This might be achieved, for example, through the issuance of regulations on record-keeping in relation to QFAs.



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3. QUALIFIED THIRD PARTY OR BRIDGE INSTITUTION

3.3.5 PIDM proposes that the Act will define a “qualified third party” in section 2 of the Act. This would be any person meeting such criteria as may be prescribed by PIDM. PIDM contemplates that such persons would (in line with the BIS Report recommendations) be another sound financial institution or a public sector entity, or an entity guaranteed by PIDM. The criteria will be published in the Gazette in due course.

Comments Received

Some of the respondents indicated that the criteria for a “qualified third party” should be provided for consultation and feedback before being published in the Gazette.

PIDM’s Response

PIDM will carry out relevant consultations prior to the implementation of the criteria for “qualified third party”.

4. NO “CHERRY PICKING”

3.3.9 The proposed power to transfer will not allow any “cherry-picking” of the qualified financial transactions. On PIDM’s exercise of such power, either all or none of the transactions between the same parties must be transferred out.

Comments Received

Some of the respondents sought clarification on whether this would apply to all QFAs between the counterparty and the failed MI and the counterparty’s affiliates and the failed MI, and whether it will also extend to the transfer of the collateral agreements between the parties.

PIDM’s Response

The current “no-cherry picking” rule in the PIDM Act 2011 relates to the QFAs between PIDM and the counterparty in question, and not to its affiliates. PIDM will consider this further as a matter of policy.

5. STATUTORY NOVATION

3.3.10 PIDM proposes to incorporate statutory provisions that would allow the transfer of the qualifying financial transaction (essentially a novation) by way of a statutory “transfer instrument”.



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Comments Received

One of the respondents sought further clarification on the “transfer instrument” and the implication if the novation was not effected within the stipulated time and PIDM’s authority in ensuring parties execute and give effect to the novation.

PIDM’s Response

The statutory novation will be effected by a transfer instrument executed by PIDM, and this is permitted under the law. It will not require execution by any other party.

6. RIGHT OF PIDM TO TERMINATE

3.4 In order to avoid a situation where the counterparty has the right to terminate a transaction with a member institution but refuses to so terminate (and PIDM considers such termination to be the appropriate action to be taken), PIDM proposes to provide for the ability to declare the termination instead.

Comments Received

The main concern of some of the respondents is that the sanctity of contracts freely entered into should be upheld and regulatory authority should be slow to impose extra-contractual remedies.

PIDM’s Response

PIDM acknowledges that its statutory obligation to carry out its mandate with least cost to the financial system must be balanced against the rights of parties under contracts freely entered into. In this regard, PIDM would only exercise such power in a situation where termination of the derivatives transaction was justified.

B. IN RESPECT OF PARAGRAPH 4 OF THE CONSULTATION PAPER, UNDER THE HEADING “AFFECTED PERSONS”

1. DEFINITION OF “AFFECTED PERSON”

4.2.3 PIDM proposes to amend the current definition of “affected person” in section 2 of the Act so as to explicitly exclude member institutions from the definition. This means that the power in section 27 of the PIDM Act 2005 will only be applied in respect of non-member institutions.



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Comments Received

The respondents supported the proposal, with one respondent indicating that the MI's affiliates, subsidiaries and other related entities should also be explicitly excluded.

PIDM's Response

PIDM did not exclude the MI's affiliates, subsidiaries and other related entities from the current definition of affected persons. This is reflected in section 2(1) of the PIDM Act 2011.

2. TEMPORARY DELAY OF IMMEDIATE OPERATION OF THE EARLY TERMINATION PROVISIONS

4.2.7 On the conservatorship of an affected person:

- (a) PIDM proposes amendments to the Third Schedule of the PIDM Act 2005, so that a counterparty may terminate qualified financial transactions, provided that PIDM does not transfer the transactions within a period of ten (10) days from the date of appointment of the conservator.
- (b) Transfers will be to qualified third parties, which are persons that meet the criteria prescribed by PIDM, and utilising the statutory "transfer instrument" mechanism.
- (c) There will be no "cherry-picking".

4.2.8 PIDM also proposes to incorporate a statutory provision to terminate a qualified financial transaction where a counterparty of the affected person who is entitled to so terminate, fails to do so.

Comments Received

Whilst the respondents supported the proposal to allow for the termination and set off of qualified financial transactions on appointment of conservator, some of them indicated that there should not be any temporary delay at all with regard to an affected person.

PIDM's Response

Under the PIDM Act 2005, upon the appointment of a conservator over an affected person, there will be a moratorium of 12 months, which may be extended by PIDM. Therefore, the counterparty in respect of a QFA entered into by the affected person will not be able to terminate the QFA during that period at all.

What PIDM proposes to implement is a step forward from the current position, as it allows for a set-off and termination, subject to a delay.



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At the same time, it is in line with PIDM's mandate to have the power to suspend such close-out and suspend. This is because, as we have seen in the experience of other jurisdictions, systemic risks can arise not only from MIs, but from other financial and other institutions, such as investment banks and hedge funds.

PIDM's position is that the proposed 10-day period is needed to identify the QFAs entered into by the affected person, analyse them and determine if they should be transferred out.

As with MIs, to allow for greater flexibility, instead of having the 10-day period spelt out in primary legislation, PIDM will specify the 10-days in regulations.

PIDM would note also that, in response to PIDM's consultation on the similar subject matter in 2007, respondents to that consultation did in fact propose a period of 10 days.

C. CLARIFICATION IN RELATION TO EARLY TERMINATION NOTICE

One of the respondents had sought clarification in relation to a provision in the PIDM Act 2005 and its effect on specific provisions in the ISDA agreements.

Comments Received

Section 76(1)(f) of the PIDM Act 2005 provides that "no person may terminate ... any agreement with the member institution ... as from the date of assumption of control of the member institution ..."

Pursuant to section 6(a) of the ISDA Master Agreement, the non-defaulting party "may by not more than 20 days notice to the Defaulting Party ... designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding Transactions".

Market participants have assumed that the effect of paragraph 76(1)(f) is that so long as the early termination notice has been delivered before the date of assumption of control of the MI, it will be effective even though the designated Early Termination Date falls after the date of assumption of control.

PIDM's Response

The power of suspension will not affect an early termination notice delivered before the date of assumption of control of an MI or the appointment of a receiver for an MI or the appointment of a conservator for an affected person, designating an early termination date falling after such assumption of control or appointment. In other words, an early termination notice delivered before the assumption of control of an MI or the appointment of a receiver for an MI or the appointment of a conservator for an affected person, designating an early termination date falling after such assumption of control or appointment, would be effective despite the stay.

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