



Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

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

ISSUE DATE : 30 JUNE 2010
CLOSING DATE : 30 JULY 2010



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1.0 INTRODUCTION

1.1 BACKGROUND

1.1.1 The recitals in the Malaysia Deposit Insurance Corporation Act 2005 (“the Act”) states, among other matters, that:

“...the stability of the financial system is a key determinant of the economic growth and prosperity of Malaysia; ...”; and

“.. special provisions are required in the public interest to empower the Corporation to implement promptly the resolution actions set out in this Act at a minimum cost to the financial system...”.

1.1.2 The objects of Perbadanan Insurans Deposit Malaysia (“PIDM”) under section 4 of the Act are to:

- (i) administer a deposit system under the Act;
- (ii) provide insurance against the loss of part or all deposits of a member institution;
- (iii) provide incentives for sound risk management in the financial system; and
- (iv) promote or contribute to the stability of the financial system.

1.1.3 In achieving its objects under paragraphs 1.1.2(ii) and (iv) above, PIDM shall act in such manner as to minimise costs to the financial system.

1.1.4 In furtherance of its objects, PIDM may exercise any or all of its powers under the Act including the following.

- (i) Member institutions (licensed banks). PIDM has the power to assume control of the whole or part of the assets, liabilities, businesses and affairs of a member institution, including carrying on its businesses, managing its assets and liabilities and disposing of its assets, or appoint any person to do so on behalf of PIDM, once PIDM has received a notification from Bank Negara Malaysia (“BNM”) that the member institution has ceased or is likely to cease to be viable.¹

¹ Section 70 and paragraph (c) of subsection 71(1) of the Act.



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- (ii) An “affected person”. PIDM has the power to appoint a conservator to administer an affected person (as defined in the Act) if PIDM is satisfied that:
- (a) the primary affected person is unable or likely to be unable to pay its debts, or is unable or likely to be unable to fulfil its obligations to its creditors;
 - (b) the survival of the primary affected person and the whole or any part of its assets as a going concern may be achieved;
 - (c) a more advantageous realisation of the assets of the primary affected person may be achieved than a winding-up; or
 - (d) the appointment may achieve a more advantageous realisation or a more expeditious settlement of a liability owed by any person to the Corporation or any subsidiary of the Corporation.²

1.1.5 The International Swaps and Derivatives Association, Inc. (“ISDA”), which represents participants in the privately negotiated or over-the-counter derivatives industry, has obtained legal opinions from Malaysian counsel on the enforceability in Malaysia of provisions relating to:

- (i) the netting or setting off of offsetting positions between counterparties;
- (ii) the prompt access to collateral; and
- (iii) the close-out or termination of positions quickly without being subject to prolonged legal stays;

(collectively, “close-out netting provisions”) contained in ISDA agreements.

1.1.6 The Malaysian counsel has opined that, in general, the close-out netting provisions are enforceable, subject to certain qualifications in the Pengurusan Danaharta Nasional Berhad Act 1998 (“the Danaharta Act”) and the Act.

² Subsection 27(1) of the Act.



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1.1.7 The provisions in the Act that impact the close-out netting provisions are sections 27, 76, 80 and the Third Schedule. The issue posed by the Danaharta Act will not be addressed in this consultation paper.

1.1.8 Therefore, Malaysia is not considered a “netting friendly jurisdiction” status by ISDA by virtue of the legislative provisions mentioned above.

1.2 CONSULTATION PAPER IN JULY 2007 AND RESPONSES

1.2.1 PIDM issued a consultation paper on 23 July 2007 (“July Consultation”) relating to certain proposed measures to help achieve a confirmation on the enforceability of close-out netting in Malaysia, under the Act specifically.

1.2.2 Following the July Consultation, PIDM issued the Malaysia Deposit Insurance Corporation (Financial Transactions or Agreements under section 80(h)) Regulations 2008 (“Regulations”), which came into effect on 30 October 2008. The Regulations have expanded the list of financial transactions, largely as drafted by ISDA. These are now exempt from the stay provisions in section 76 of the Act. By virtue of the Regulations, the termination and netting of obligations under these financial transactions are not prevented by the stay provisions during an assumption of control of a member institution under the Act.

1.2.3 Following consultation responses, PIDM did not issue an equivalent policy statement in relation to such financial transactions with affected persons.

1.2.4 The July Consultation made it clear that PIDM planned to conduct a comprehensive review of the Act. PIDM also stated that it would revisit the provisions in the Act as well as any changes it had made to help achieve the “netting-friendly jurisdiction” status in the course of the review. This was, in particular, to ensure that PIDM’s effective and efficient achievement of its mandate.



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2.0 COMPREHENSIVE REVIEW OF THE PIDM ACT AND CONSULTATION

2.1 Since then, PIDM has completed a comprehensive review of the Act. PIDM has identified certain areas relating to financial transactions with a member institution or an affected person that require legislative amendments.

2.2 PIDM is now issuing, for consultation, proposals to amend provisions in the Act in relation to derivatives in Malaysia.

2.3 PIDM hereby invites written comments from interested parties on the proposals and issues raised in this consultation paper.

2.4 Written comments should be submitted no later than **30 July 2010** to:

Lim Lee Na/Lim Tai Ching
Perbadanan Insurans Deposit Malaysia
P.O. Box 13071
50798 Kuala Lumpur

Enquiries: 03-21737436
E-mail: legal@pidm.gov.my

2.5 Your comments may be made public by PIDM. If you do not want any of your comments to be made public, please indicate accordingly in your response.

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3.0 PROPOSED AMENDMENTS IN RELATION TO MEMBER INSTITUTIONS

3.1 SECTIONS 76 AND 80 OF THE ACT

3.1.1 Once PIDM or the appointed person assumes control of a member institution, section 76 of the Act stipulates, *inter alia*, that, as from the date of the assumption of control of the member institution by PIDM or the appointed person, as the case may be:

- (i) no creditor of the member institution has any remedy against the member institution or its assets;
- (ii) no creditor has any right of set off against the member institution, which for greater certainty, does not include the consolidation of accounts maintained in the normal course for the purpose of providing clearing and settlement services or the services referred to in section 79 of the Act; and
- (iii) no person may terminate or amend any agreement with the member institution or claim an accelerated payment under any such agreement with the member institution by reason only of —
 - (a) the insolvency of the member institution;
 - (b) a default, before the assumption of control under paragraph (c) of subsection 71(1) by PIDM or the appointed person, as the case may be, takes effect, by the member institution in the performance of its obligations under the agreement; or
 - (c) assumption of control under paragraph (c) of subsection 71(1) by PIDM or the appointed person, as the case may be,

(collectively, “the stay of proceedings”).

3.1.2 By virtue of section 80 of the Act, the stay of proceedings does not apply to certain transactions listed in section 80, which may be set off and terminated in accordance with their terms.

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3.1.3 As noted in paragraph 1.2.2 above, the Regulations have also expanded the list in section 80. Therefore, the current list of transactions that are not subject to the stay provisions in section 76 are as follows:

- (i) a currency or interest rate swap agreement or future or option;
- (ii) spot, future, forward or other foreign exchange or forward rate agreement;
- (iii) a commodity or basis swap;
- (iv) a repurchase agreement;
- (v) any derivative relating to bonds or other debt securities or any equity or credit derivative;
- (vi) any derivative, combination or option in respect of, or agreement similar to, an agreement or transaction referred to in paragraphs (i) to (v);
- (vii) any master agreement in respect of any agreement or transaction referred to in paragraphs (i) to (vi);
- (viii) a guarantee of the liabilities under an agreement or transaction referred to in paragraphs (i) to (vii);
- (ix) equity derivative such as an equity swap, equity index swap, equity forward, equity option and equity index option;
- (x) derivative relating to bonds or other debt securities or a bond index or other debt security index such as a total return swap, and swap, forward, option and index option of bonds or other debt securities;
- (xi) credit derivative such as a credit default swap, credit default basket swap, total return swap and credit default option;

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- (xii) agreement to buy, sell, borrow or lend securities, or a combination of such activities, such as a securities lending agreement and securities buy-and-sell-back agreement;
- (xiii) agreement to buy, sell, borrow or lend commodities, or a combination of such activities, such as a commodities lending agreement and commodities buy-and-sell-back agreement;
- (xiv) title transfer collateral agreement relating to any agreement or transaction specified in paragraphs (ix) to (xiii) above and paragraphs 80(a) to (g) of the Act; and
- (xv) any agreement and transaction, other than those specified in paragraphs (i) to (xiv) above and paragraphs 80(a) to (g) of the Act, where such agreement and transaction and the asset underlying such agreement and transaction are Syariah compliant.

3.2 PROPOSAL TO AMEND SECTION 80 – QUALIFIED FINANCIAL TRANSACTIONS

- 3.2.1 PIDM proposes to amend Section 80 so as to consolidate the list of derivatives that are not subject to section 76 in the Act.³
- 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.
- 3.2.3 PIDM also proposes to define those financial transactions in the amended section 80 as “qualified financial transactions” in section 2 of the Act.

³ This will entail the repeal of the Regulations, once the list is consolidated in section 80

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

3.3.1 The Bank of International Settlement's final "Report and Recommendations of the Cross-border Bank Resolution Group" was issued in March 2010, following consultations since September 2009 ("BIS Report").

3.3.2 Recommendation 9 of the BIS Report states:

"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. Where a transfer is not available, authorities should ensure that contractual rights to terminate, net, and apply pledged collateral are preserved. Relevant laws should be amended, where necessary, to allow a short delay in the operation of such termination clauses in order to promote the continuity of market functions."

3.3.3 As noted in the BIS Report:⁴

"While the current protections for financial contract termination and close-out netting may reduce the risk of contagion during normal markets, if all counterparties of a failing bank exercise the right to terminate immediately financial contracts, net exposures, and liquidate collateral upon the initiation of resolution measures, it will undermine financial stability and accelerate contagion during crises."

Proposal to allow for transfer

3.3.4 PIDM therefore proposes legislative provisions in line with the recommendations of the BIS Report. This would allow for the Corporation, on assumption of control of a member institution, to transfer qualified financial transactions to a "qualified third party" within a specified period of time. If not so transferred, the transactions may be terminated in accordance with their terms.

⁴ Page 42

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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.

3.3.6 The proposed provision will specifically allow for the transfer of the qualified financial transaction to a bridge institution.

Temporary delay of immediate operation of early termination rights

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.

3.3.8 PIDM considers that the proposed period is necessary to enable PIDM to gather and assess the relevant information to make an informed determination. On assuming control of the member institution, adequate time is needed for PIDM to ascertain the total number of outstanding derivatives, the member institution’s hedging strategy, derivatives-related monitoring processes and controls, and whether the derivatives are “plain vanilla” or complex, as well as to assess the key risks involved.

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.

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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3.4 RIGHT OF PIDM TO TERMINATE

In order to avoid a situation where the counterparty has the right to terminate a transaction with a member institution but refuses to so terminate⁵ (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.

4.0 “AFFECTED PERSONS”

4.1 SECTION 27 AND THE THIRD SCHEDULE OF THE ACT – BACKGROUND

4.1.1 Section 27 and the Third Schedule relate to PIDM’s power to appoint a conservator over an “affected person” and the powers of the appointed conservator.

4.1.2 Section 2 of the Act defines an “affected person” as follows:

- (i) any company owing a duty or liability under an Islamic financing facility or a conventional credit facility to the Corporation or any subsidiary of the Corporation, whether present or future, or whether vested or contingent;
- (ii) any subsidiary of the company referred to in paragraph (a);
- (iii) any company which has provided security for the performance of or discharge of a duty or liability owed by any person to the Corporation or any subsidiary of the Corporation, whether present or future, or whether vested or contingent; or
- (iv) any company where at least five percent of its share capital has been charged, pledged or mortgaged by any person to secure the performance of or discharge of a duty or liability owed by any person to the Corporation or any subsidiary of the Corporation, whether present or future, or whether vested or contingent.

⁵ As experienced in some other jurisdictions e.g., the Lehman Brothers case.



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An affected person could be a borrower of a loan provided by a member institution or a security provider for such a loan (where such loan has been acquired by PIDM from the member institution).

- 4.1.3 Paragraphs 4 and 17(1) of the Third Schedule of the Act provide for a moratorium, once a conservator is appointed over an affected party. Under this scheme, agreements with the affected person cannot be set off without the consent of PIDM upon appointment of a conservator, and an appointment of a conservator will not be regarded as giving rise to a right to terminate the agreements.

4.2 PROPOSED AMENDMENTS

Definition of “affected person”

- 4.2.1 An affected person is intended to be, for example, a borrower of the member institution. However, the current definition of “affected person” under the Act is wide and could conceivably also include a member institution.⁶ This is however not the policy intent.
- 4.2.2 Under the Act, PIDM already has wide powers to deal with a troubled member institution. It is not intended that PIDM would appoint a conservator over the troubled member institution and make use of the conservator powers set out in the Third Schedule to intervene in or resolve the troubled member institution.
- 4.2.3 Accordingly, 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 will only be applied in respect of non-member institutions.

⁶ A member institution is a commercial or Islamic bank. It is an incorporated company under the Companies Act 1965. The current definition in section 2 of the Act could conceivably capture a member institution that takes a loan from a third party or provides security for a third-party loan (and such loan is then acquired by PIDM).

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Proposals to allow termination and close-out netting

- 4.2.4 Paragraph 4 of the Third Schedule provides that the appointment of the conservator shall not be regarded as placing the conservator, or the affected person to be in breach or in default of any contract, nor be regarded as giving a right for any person to terminate, cancel or modify an agreement.
- 4.2.5 Paragraph 17(1)(e)(iv) of the Third Schedule provides that, on appointment of the conservator, there is a moratorium, during which no person may set off any debt owing to the affected person in respect of any claim against the affected person, except with the prior written consent of the Corporation.
- 4.2.6 PIDM proposes to allow for the termination and set-off of qualified financial transactions on appointment of the conservator, subject to the temporary delay in immediate operation of early termination provisions in the agreements.

Temporary delay of immediate operation of the early termination provisions

- 4.2.6 PIDM proposes similar powers to those discussed in paragraph 3.3 above on assumption of control of a member institution, in respect of a conservatorship of an affected person, except that PIDM will (if it does decide to transfer) only transfer such transactions to a qualified third party and not to a bridge institution.
- 4.2.7 In summary:
- (a) PIDM will propose amendments to the Third Schedule of the Act, 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”.



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4.2.8 Similar to the proposal in paragraph 3.4 above, 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.

5.0 RESPONSES

The views and comments of interested parties are sought in relation to the proposals above.

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