

10 Mac 2011

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Puan

2010 SUPERVISORY LETTER

We refer to the 2010 Supervisory Letter dated 30 December 2010 and email correspondence dated 25 January 2011 from Bank Negara Malaysia (BNM) on the above matter.

We wish to inform you that the above 2010 Supervisory Letter was tabled at the Board of Directors meeting held on 1 March 2011 as requested by BNM. The Board had reviewed and discussed on the issues raised in the letter from BNM, and approved the action plans as attached to this letter for BNM's information.

Sekian, terima kasih.

Yang benar

2010 BNM Composite Risk Rating Observations / Issues

(A) Potential Risk Areas

#	Observations per BNM Letter dated 30 December 2010	Actions/Processes in place
	<p>9.1 Potential Risk Emanating from Consumer Banking Portfolio</p> <p>9.1.1 The bank has recorded a contraction in its overall mortgage portfolio by RM0.6b or 6.3%, from RM10.5b as at 31 December 2009 to RM9.8b as at 30 September 2010. However, the 30 day-past-due (dpd) has increased to 5.43% or RM534.5m (Dec'09: 4.4% or RM465.0m). In addition, there were signs of heightened risk profile of the mortgage portfolio as reflected by a moderate upward trend in the R&R loans from RM958.1m (Dec'09) to RM1,043.5m (Sept'10). The bank has also relaxed its underwriting standards since second half of 2009, where its Loan to Value (LTV) was increased from its previous capping of 80% to a maximum of 89% on a selective basis.</p> <p>9.1.2 On the contrary, credit card portfolio recorded a significant growth in 2010 of 16.3% as compared with 2.2% growth in December 2009. The loans under 30dpd and 90dpd have increased to RM338.0m (Dec'09: RM334.0m) and RM93.0m (Dec'09: RM90.0m) respectively. The bank's R&R loans have also increased significantly by 8.4% or RM53.9m from December 2009 coupled with higher 30dpd (Sept'10: 11.1% ; Dec'09: 9.8%) and 90dpd (Sept'10: 2.3% ; Dec'09: 1.9%).</p>	<p>The Board noted and deliberated on BNM's comments.</p> <p>██████ Berhad employs a proactive approach in controlling and managing portfolio risk. Some of the critical reviews conducted form the basis of extending, maintaining or restricting customer exposure. These includes :</p> <ul style="list-style-type: none"> • Usage of monthly calculated dynamic behavior score, particularly for unsecured products like credit cards • Leverage bureau performance at a holistic level and such information is being reviewed on quarterly basis to ensure that customer performance is monitored constantly. • Mortgage products - periodic reviews of property values as active collateral management and early identification of potential loan quality deterioration. <p>In addition, accounts that display warning signals are highlighted immediately to Collections for early actions.</p> <p>On relaxation in underwriting standards made with respect to the recent increase in Loan to Value Ratios for Mortgages, such relaxation is allowed only to very selective segments:</p> <ol style="list-style-type: none"> 1) Customers with higher credit score 2) Customers who are not over-leveraged

#	Observations per BNM Letter dated 30 December 2010	Actions/Processes in place
	<p>The increasing trends in loan delinquencies and rehabilitation of consumer loans are expected to continue in the near future, mainly driven by the global economic challenges and rising interest rate environment which may affect the repayment capacity of the borrowers.</p> <p>In this regard, the bank should put in place active portfolio management to enable timely interventions in containing emerging risks at the early stage. The bank is also expected to ensure the relaxation in its underwriting standards will not compromise the overall quality of its mortgage portfolio.</p>	<ol style="list-style-type: none"> 3) Property Value > RM 300M 4) Property to be in areas with good occupancy, amenities, etc (reviewed independently by risk management) 5) Valuation of property and evaluation of trend over time to ensure resistance to economic cycles <p>Apart from the above criteria, there is an additional cap on such loans to a maximum of 20% of total loan bookings and receivables.</p>
	<p>9.2 Increasing Risk from Foreign Exchange (FX) Activities</p> <p>The bank's USD Net Open Position has been trending upward since May 2010 with its exposure culminating at 25% of capital base (USD292.0m) in September 2010. Given the increasing volatility and heightened uncertainties in the FX market, the risks emanating from its FX positions may pose a significant threat to the bank's earnings, if not well mitigated. The bank is expected to ensure that its FX risk-taking activities are within its risk tolerance levels and subject to increased oversight by the Board and senior management. In addition, measures</p>	<p>The Board noted BNM's comments.</p> <p>While there is a build-up of net open position, the Bank does have the necessary processes or control in proactively managing such exposures while maximizing the return.</p> <p>The control mechanisms that the Bank employs in managing the overall FX activities of the Bank include :</p> <ul style="list-style-type: none"> • Trading limits are being assigned to individual traders and the trading desk, which cap the amount of exposure the Bank can hold at any one point in time.

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	<p>must be in place to ensure that the bank does not facilitate any speculative trading of Ringgit by its customers. The bank is required to verify that all customers' FX transactions are adequately supported by genuine underlying trade transactions and such verifications are undertaken on a continuous basis.</p>	<ul style="list-style-type: none"> • Daily monitoring process (Management Action Trigger / MAT) , which highlights the P&L recorded to-date and serves as a trigger for management if the MAT limit was approaching or exceeded. • For customer related FX transactions, there is a process in place where the Bank requests supporting documentation from customers to substantiate the underlying trades. This is done in the form of undertaking a monthly sampling of outstanding FX contracts - by requesting & then verifying documentation from clients.

(B) Areas Require Action

#	Issues / Comments per BNM Letter dated 30 December 2010	Action Plan
1	<p>Ineffective Implementation of Continuity of Business (CoB) Plan</p> <p>There was a prolonged delay of 10 hours during the CoB activation in September 2010 due to the bank's upgrading of its inward check clearing system which triggered for manual intervention. The bank experienced similar delay on 3 February 2010 due to the unsuccessful activation of CoB, impelled by the failure of its RENTAS settlement system. The recurrence of such incidence reflected the shortcomings in the bank's risk management in managing its operational risk.</p> <p>It is imperative that the bank implements proper measures to ensure the effectiveness of its CoB plan during system downtime. Amongst others, [REDACTED] is required to continuously perform periodic reviews on its system's capacity in order to ensure the sustainability of all critical systems in supporting the bank's operations under BAU and unexpected crisis or circumstances. Changes and upgrading of all core systems must be undertaken in a controlled environment and supported by robust policy, procedures and internal controls.</p>	<p>1. E-SPICK - CLEARING SYSTEM issue in Sept 2010</p> <p>Issue</p> <ul style="list-style-type: none"> • 25 Sept 2010 - Delay of 10 hours in bringing up contingency server • Business Recovery Times Objectives (RTO) not met. <p>Impact</p> <ul style="list-style-type: none"> • Manual workaround was invoked and all instruments were cleared the same day. • GL Postings were completed on time. • No impact to customers. <p>Root Cause</p> <p>Corruption of operating system component (windows registry) arising from program level mirroring done during a scheduled Operating System conversion.</p> <p>Preventive Measures</p> <p>COB recovery procedures surrounding System Migration and Conversion has been reviewed with Senior Management and the following additional measures were implemented on 12 Nov 2010 :-</p> <ol style="list-style-type: none"> a. For any system conversion or migration, program level mirroring will be disabled. b. For critical systems, the COB environment will be loaded with production data as hot backup to support immediate rollback in event of conversion failures.

#	Issues / Comments per BNM Letter dated 30 December 2010	Action Plan
1		<p><u>2. Rentas - issue in Feb 2010</u></p> <p>Issue</p> <ul style="list-style-type: none"> • Unsuccessful activation of the COB System. <p>Impact</p> <ul style="list-style-type: none"> • As provided in the RENTAS guidelines, Citi invoked the ultimate contingency of operating from BNM's Contingency facilities with strong support from MYClear. • Processed a total of 1,254 transactions amounting to RM11 billion (Outgoing : 814 transactions & RM2.3 billion and Incoming 440 transactions & RM9.1 Billion). Only 8 transactions were not processed and 2 of which customers requested for back valuation (RM493.15 to Standard Chartered). <p>Root Cause</p> <p>The problems encountered were at encryption (error 33) and application (error 528) levels on both the COB and Production servers (as the versions were identical) and supporting vendor was not able to immediately resolve issue.</p> <p>Preventive Measures</p> <ul style="list-style-type: none"> • [REDACTED] participated as one of the pilot Bank to test on ePKI between March 15 to 19, 2010 [REDACTED] has provided sign off to the testing. • [REDACTED] has also arranged for scheduled server reboot every fortnight to prevent the re-occurrence of print spool issue. • [REDACTED] has migrated to a 'higher-end' Rentas production server. The server migration was a planned migration and BNM vendors have been notified at the beginning of 2010. This has further enhanced system performance.

#	Issues / Comments per BNM Letter dated 30 December 2010	Action Plan
2	<p>Improper Treatment on Reclassification of Restructured and Rescheduled (R&R) Loans</p> <p>The bank's current practice allows R&R loans to be reclassified as non-impaired upon rescheduling or restructuring of loans. The bank's R&R loans as at 30 September 2010 stood at RM1.8b, of which, RM99.2m or 5.6% turned impaired after being restructured or rescheduled. The impairment level for rehabilitated loans increased by RM3.4m or 3.6% as compared with RM95.7m or 5.8% recorded in 2009.</p> <p>In ensuring consistency and in line with prudent practices, the bank is required to determine the 'observation period' to ascertain the capabilities and capacity of borrowers in meeting with the new repayment terms before reclassification of accounts as non-impaired. The determination of 'observation period' and its implementation must be adequately supported by a sound policy approved by the Board.</p>	<p>Risk has determined the observation period to be 3 months. This is based on historical observation of the payment behavior after the restructuring and rescheduling exercise.</p> <p>The accounts that are less than this newly determined observation period has since been classified as "impaired" in the 31 December 2010 accounts.</p>
3	<p>Role of Nomination Committee to Improve the Effectiveness of Board Oversight Function</p> <p>Board comprised 7 members, with 3 independent directors that comply with the requirement as stipulated by BNM/GP1. However in view of the changing regulatory requirements, financial landscape and global outlook as well as expansion in the bank's business and operations, there is a need for the NC to re-assess the effectiveness of the Board's composition and required skill mix. The Board relies on the banking expertise from executives as none of the independent and non-executive directors have commercial banking or risk management experiences. There is a need to ensure a balanced Board's composition between the independent and non-independent directors with the right skill mix and expertise to ensure adequate check and balance as well as effective Board oversight function.</p>	<p>With the request from Bank Negara in its letter dated 27 Oct 2010 on the approval of re-appointment of independent directors, the Nominating Committee had discussed during its meeting on 6 December 2010 (ie before the BNM's Composite Risk Rating meeting on 14 Dec 2010) and evaluated the need to increase the number of independent directors, and concluded there is no need to increase the number of independent directors as the current composition and size is functioning well.</p> <p>The Board has taken cognizance of these comments in the Supervisory Letter and will take into account these comments in the future appointments of director candidates. The Board is of the view that the current board composition and structure is sufficient as the Board has the adequate skill mix and expertise.</p>

#	Issues / Comments per BNM Letter dated 30 December 2010	Action Plan
3		<p>Our independent directors regularly attend courses and briefings by [REDACTED] key personnel to update themselves on [REDACTED] businesses.</p> <p>The Board also recognized the scarcity of independent directors with commercial banking experience and it is not easy to get such individuals to sit as independent directors.</p>
4	<p>Inadequacies in Islamic Banking Window (IBW) Operations</p> <p>8.4.1 In view of the resignation of the Compliance and Control Officer for the IBW operations in October 2010, it is imperative for the bank to identify the successor immediately, to ensure that the IBW operations remain efficient and in conformity with Shariah requirements. The vacancy will pose greater operational and Shariah risks and affects the bank's implementation of Shariah Governance Framework issued by BNM.</p> <p>8.4.2 The IBW operations recorded a marginal business growth of 11.9% in 2010 albeit its financing assets contracted by 3.1% or RM16.3m. The Islamic business remains concentrated in treasury activities since its incorporation and its contribution to MIFC's agenda is relatively marginal as compared with its peers. In this regard, there is a need for the bank to re-assess the strategic direction of its IBW operations to ascertain the business viability and strategic focus moving forward.</p>	<p>The new Islamic Control Officer, Mohammed Imad Ali, has since been appointed on 31 January 2011.</p> <p>[REDACTED] Berhad's strategy for Islamic business is to focus on customers' need and on areas where it has strong competitive advantage such as treasury, transaction services and wealth management.</p> <p>This can be clearly seen from the various products and solutions provided by [REDACTED] over the years. This includes Islamic Structured Investment, both to bank's own customers and other financial institutions, Islamic Custody Services, Islamic mortgage and the Bank also acts as distributor of foreign currency investment products which invest into Islamic investments.</p> <p>The operation under the Islamic Window will continue to be used to meet customer needs.</p>