MONITORING AND MANAGEMENT OF RISK

Intensified Surveillance of Systemic Risk in Ensuring Market Resilience

The GFC in 2007-2009 highlighted that systemic risk is an important concern given the complex inter-linkages and inter-connectedness of the financial system. Since then, the focus has been given to address the risk of failure of financial institutions within the system that could result in a severe systemic concern.

However, the COVID-19 situation at the beginning of 2020 has given rise to a new dimension of systemic risk concern. The pandemic has caused countries globally to resort to partial or full lockdown to contain the spread of the virus. It has drastically reduced the level of economic activities, subsequently causing a fall in asset prices and in turn, gradually leading to potential vulnerabilities in the capital market. Over the period of lockdowns, there has also been an increase in retail investors' participation in the stock market across the globe.

Against this backdrop, the SC enhanced its vigilance to monitor uncertainties and volatility in the capital market arising from geopolitical concerns and global responses to COVID-19. Early detection of emerging risks, trends and vulnerabilities is vital at this stage to prevent any build-up of systemic risks. The crisis simulation exercise carried out in 2019 had also equipped the SC with better preparedness to manage current market conditions.

Over this period, the SC's Systemic Risk Oversight Committee (SROC) met frequently to deliberate concerns emanating from various segments across the capital market, including identifying potential stress points and calibrating appropriate responses to manage or mitigate potential and emerging risks. Monitoring intensified for the domestic equity and bond markets, foreign fund flows, trade participants and commodities prices, while keeping watch on COVID-19-related specific regulatory interventions in other jurisdictions. Analysis and assessments also cut across other asset classes, which included the fall of oil prices due to shrinking demand caused by the lockdowns and the surge of alternatives assets such as gold and digital currencies.

Joint regulatory discussions continued to be conducted in 2020 with other authorities such as BNM and Labuan Financial Services Authority (Labuan FSA) through the Macro Risk Focus Group and Financial Stability Committee respectively. The SC also carried out regular engagements with market participants, taking into consideration the dynamic feedback mechanisms in identifying potential areas of systemic risk within the financial and capital markets in Malaysia.

These have enabled the SC to make proactive and measured decisions on appropriate regulatory and policy responses such as the temporary suspension of short selling and revision of price and circuit breaker limits. Pursuant to that, the capital market continued to operate in a stable, fair and orderly manner.

Assessment of Corporate Bond Market

Given the potential impact of COVID-19 on debt issuers, the SC proactively monitored corporate bond issues originating from vulnerable business sectors such as oil and gas, retail and hospitality as well as aviation.

Several corporate bond issuers had requested investors' indulgence for exemptions in either payment of coupon, profit or principal or extension of time to meet agreed upon financial ratios as well as other forms of refinancing. These corporate bond issues, however, make up a very small portion of the corporate bond and sukuk market, which demonstrated the overall strength and diversity of the bond market despite economic downturn.

Six rating downgrades were observed in 2020 compared to seven in 2019. Out of these downgraded issuers, three originated from the retail and hospitality industry, two from infrastructure and one asset-backed security. As for the rating outlook, there were 16 downward revisions in corporate bond outlook in 2020 compared to six in 2019. Of these revisions, five issuers were revised from positive to stable outlook, and 11 issuers revised from stable to negative outlook.

Risk Assessments on Various Components of the Capital Market

EQUITY MARKET AND INFRASTRUCTURE

- Sufficient domestic liquidity to facilitate efficient investment activities.
- Market-wide circuit breaker and price limit on equity are in place as part of the risk management mechanism to address excessive market volatility. In 2020, no circuit breaker was triggered.
- Securities and Derivatives Clearing Guarantee Funds are available to manage any sudden surge of stress.

BOND MARKET

- Yield movements were in line with other regional markets amid accommodative monetary policy.
- Corporate bond default rate remained low.

LISTED COMPANIES

- Corporate earnings in 2020 were significantly impacted by business disruptions due to the implementation of MCO, particularly in Q2 2020 where a year-on-year decline of over 70% in earnings was reported. In Q3 2020, PLCs' earnings recorded a quarter-on-quarter recovery exceeding 260%, mainly attributed to the resumption of businesses and continued demand for medical gloves.

INVESTMENT FLOWS

- Foreign equity holding fluctuated below its 5-year average amid continuous net outflows from the equity market.
- Foreign outflow in equity is consistent with other emerging markets. Ample domestic liquidity provided by local institutions and retail investors.
- Foreign holding in the bond market is below the 5-year average mainly due to the large volume of MGS that matured.

INVESTMENT MANAGEMENT

- Fund managers have measures in place to manage liquidity risk i.e. liquidity management framework to safeguard against any adverse market conditions.
- Cash and liquid assets held are sufficient to meet investors' redemption.
- The stress test results indicated that under various stress scenarios, funds are able to meet redemptions by investors.

STOCKBROKING INTERMEDIARIES

- Stockbrokers are well-capitalised, supported by sufficient liquidity buffers to address any realised or potential losses that may arise during times of stress.
- The current risk-based capital position remained above the prescribed minimum financial requirements.

Assessment of PLCs for Resiliency and Integrity

The pandemic containment measures gave rise to potential risks to the sustainability of businesses and operations of PLCs. Sudden business failures due to the challenging economic conditions may result in losses to investors in both the equity and bond markets. In addition, some listed companies sought business opportunities beyond their core principal activities and announced new ventures into health-related segments that support the fight against COVID-19. The increase in such activities and announcements may lead to disclosure risks in relation to the quality of information needed for investment decisions.

Accordingly, targeted surveillance and risk assessments were carried out on financial resilience and debt exposures of PLCs as well as the adequacy of disclosures to enable informed investment decisions.

Stress testing of financial resilience of PLCs

Monitoring of listed companies in high risk sectors such as hospitality and aviation were intensified, to assess their ability to withstand the financial stress. Listed companies' financial strength and agility were reviewed using financial modelling with a range of contractions in GDP for 2020. While the results of the stress test provided an early indication of the vulnerable listed companies, the SC noted that the market capitalisation of the affected companies did not form a significant portion of the overall market capitalisation of Bursa Malaysia Securities.

As part of the stress testing, the SC also evaluated PLCs' leverage positions and their ability to repay short-term debts. Based on the outcome of the evaluation, a number of listed companies with high debt exposures were identified for further risk assessment and monitoring.

Review of disclosures by listed companies venturing into health-related businesses

Given the increase in announcements by listed companies venturing into health-related businesses, the SC actively monitored and reviewed such announcements to ensure that timely, adequate and accurate information was disseminated to investors.

In June 2020, Bursa Malaysia issued an *Issuers Communication Note on Disclosure Guidance on COVID-19 Related Impacts and Investments* (Disclosure Guidance) to provide guidance and clarity to listed companies when making COVID-19 related disclosures. Furthermore, the Disclosure Guidance serves to aid and facilitate clear, balanced, fair and full disclosures to the public.

Intensified Supervisory Focus on Intermediary Risk

Supervisory focus was to ensure risks were being managed appropriately by intermediaries and that they are able to comply with their regulatory obligations despite the difficult operating environment. Accordingly, the SC adopted a more facilitative approach to better understand the operational challenges faced by the industry.

In doing so, data collection and analytics efforts were intensified. The increased frequency of data collection from intermediaries, led to swift and informed decisions on appropriate measures required to safeguard the stability of the capital market and importantly, investors' interests. For example, on 9 April 2020, the SC had issued a *Circular to Fund Management and Unit Trust Management Companies* to reiterate its expectations for intermediaries to observe among others, the principles of fair treatment of investors, practise clear and open communications, and maintain a robust client asset protection framework. Intermediaries were also reminded to properly manage the liquidity of their funds to ensure sufficiency in meeting investors' redemption requests.

Various scenarios were analysed to assess possible risk-induced events. Among others, a key area of concern was the vulnerability of the intermediaries and their clients to volatile swings in market conditions.

To that end, the SC remained in close contact with all the stockbroking intermediaries to ensure that margin financing exposures are in line with the intermediaries' risk appetite and collateral buffers.

LIQUIDITY RISK MANAGEMENT FOR FUNDS

- On 9 April 2020, the SC issued a circular to Fund Management Companies to highlight the **importance of managing funds' liquidity**, especially in mitigating potential mismatches between liquidity of the funds' underlying assets and redemption terms.
- Management companies were required to **alert the SC on any material issues or anticipated adverse circumstances** relating to the funds under their management.

The SC's key concerns focused on the **availability of liquid assets** in tandem with redemption patterns especially funds invested in thinly traded and riskier asset classes. Thus, the SC had intensified monitoring of funds liquidity risk since the beginning of MCO by:

- **Increasing reporting frequency to daily submissions** in order to receive up-to-date data on funds movements in investment holdings.
- Tighter scrutiny of funds by **setting stricter triggers** based on reported data.
- Requiring management companies to communicate with the SC in timely manner should there be **large redemption of funds and furnish the SC with relevant information** to demonstrate their capability in meeting redemption requests.

Based on the SC's continual monitoring:

- All funds have **proven to be resilient** through stressed market conditions.
- Systemically important financial institutions (SIFI) have shown that they **can readily conduct Fund Liquidity Test** with sets of mitigating actions to address the outcome of the test.
- Management companies were well aware of the best practices, Liquidity Risk Management (LRM) tools and contingency plans to ensure they were able to **meet redemption request in an orderly manner** while prioritisng fair treatment to all investors.

Capital Adequacy of Intermediaries

At the onset on the COVID-19 outbreak, the SC had promptly taken steps to assess the potential impact on intermediaries' financial positions. Throughout the period, the SC continued to perform enhanced stress testing on the financial position of stockbrokers as well as the adequacy of their action plans and risk management tools. The SC also assessed brokers' action plans to meet their capital needs should any of the stress scenarios materialise.

The SC expects stockbrokers to have in place adequate risk management controls, carry out prudent risk management measures, and maintain sufficient resources. Stockbrokers were found to have generally adopted dynamic risk parameters in line with heightened trading volume. In addition, they have continued to remain cautious in managing risk exposures in periods of high volatility.

Stockbrokers were also observed to have in place comprehensive risk management frameworks, which included the establishment of Risk Management Committees and functions. In this regard, stockbrokers had independently undertaken measures such as imposing security requirements against credit risks.

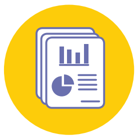
Towards this end, the industry average of risk weighted capital ratio (RWCR) of investment banks and capital adequacy ratio (CAR) of non-investment banks remained above the minimum requirement.

Ensured High Quality of Audit Conducted on PIEs

Mobility restrictions under the MCO had resulted in audit teams having limited or no access to their clients' books and records, thus, potentially affecting the progress, quality and completion of audit engagements within the planned timelines.

In April 2020, the SC's Audit Oversight Board (AOB) issued an Alert to auditors and public-interest entities (PIEs) regarding the importance of ensuring high quality audit on financial reports of PIEs under the prevailing challenging circumstances. The Alert also served to communicate the areas of focus that auditors and Audit Committees of PIEs may wish to pay particular attention to when discharging their responsibilities.

The AOB also faced its challenges of working under strict health and safety SOPs, which resulted in limited physical engagements with stakeholders and a reduction in time to complete the planned inspection programmes. Notwithstanding this, the AOB continued to discharge its regulatory functions by leveraging technology such as video conferencing for discussions or engagements with audit firms and adapting its inspection approach in 2020 to:



Increase the utilisation of data analytics to facilitate offsite monitoring of PLCs and their respective auditors; and

Incorporate thematic reviews in relation to the impact of COVID-19 and MCO to audited financial statements and auditor's reports.

A total of four audit firms and 242 audit engagements were scoped in the AOB's thematic reviews on the impact of COVID-19. The thematic reviews revealed gaps in a number of the auditors' verification of the PIE's going concern assumptions and impairment assessments, as well as the adequacy of subsequent event disclosures in the audited financial statements. Additionally, the AOB continued with inspections and covered 10 audit firms and 19 audit engagements.

GLOBAL CO-ORDINATION IN REGULATORY RESPONSE TO COVID-19

The COVID-19 pandemic caused the global financial system to experience its biggest stress event since the global financial crisis. While the cause did not emanate from the financial sector, the pandemic had created a tumultuous environment in the financial markets.

Members of the International Organization of Securities Commissions (IOSCO) including the SC co-operated to manage their responses to the risks and challenges faced by the capital markets. IOSCO is the leading international standard-setter for securities regulation, whose membership regulates more than 95% of the world's capital markets worth around US$140 trillion, in approximately 120 jurisdictions.

The pandemic highlighted the importance of global co-ordination in regulatory responses during times of market stress. Throughout extreme volatility, international regulators through IOSCO reinforced the importance of ensuring markets remain open and continue to function in an orderly manner to enable participants to price and transfer risks across asset classes. Global regulators also focused on ways to provide appropriate flexibility to help market participants address challenges arising from the pandemic. These included, among others, adjusting onsite inspections, oversight requirements, and providing flexibility on requirements related to AGMs, as well as ensuring high quality financial reporting and disclosure obligations are maintained.

As an elected member of the IOSCO Board, the SC participated in frequent information-sharing with its peers from both developed and emerging market jurisdictions to identify and mitigate issues arising from COVID-19. These included the development of IOSCO's COVID-19 repository of measures that global regulators have taken to mitigate risks to investor protection, market integrity and financial stability. The repository covered the types of measures, rationale and impact these measures have had on respective markets.

Among IOSCO's other priorities during the year were to address areas of market-based finance that are most exposed to heightened volatility, constrained liquidity and the potential for pro-cyclicality. These included examining investment funds as well as margin and other risk management aspects of central clearing for financial derivatives and other securities. Following the publication of the earlier *Report on Sustainable Finance and the Role of Securities Regulators and IOSCO*, IOSCO's newly established Board-level Sustainable Finance Task Force, which the SC is a member of, is also taking forward work on disclosure, greenwashing and ESG ratings, among others.

Substantial resources are also devoted to retail investor protection, particularly given the growing retail participation in global capital markets. To this end, the IOSCO Board's Retail Market Conduct Task Force is examining how the market turmoil caused by COVID-19 has given rise to increased misconduct in financial services for retail investors.

The SC's active participation in these areas has allowed the organisation to gain valuable insights on global regulatory developments and policy measures taken, including their effectiveness. It has helped shape its responses for the Malaysian capital market and ensured that its policies are in line with global practices.

The SC also continued to enhance its supervisory efforts through participation in regional supervisory colleges, and regular dialogues on strategic and thematic supervisory issues to keep abreast of supervisory developments across the region. In 2020, the SC with other international regulators conducted a follow-up review on market intermediaries' responses and action plans to the supervisory college feedback as well as the operational challenges arising from COVID-19 and emerging supervisory concerns.

In 2020, to have the maximum reach, the IOSCO Asia Pacific Hub (The Hub) hosted by the SC in its premises, leveraged heavily on technology to undertake its capacity-building activities. The Hub produced a series of webcasts on the implications and various issues of COVID-19, including the outlook to regional financial markets, financial reporting and disclosures, cyber security, retail investor protection and sustainable finance.