Take5 for business

Volume 14 Issue 8 - 17 September 2025

Large exposure limits in Malaysia: A new generation of capital reforms

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Strengthening the framework for large exposures

Malaysia's exposure draft (ED) on large exposures limits (LEL), issued on 13 December 2024 by Bank Negara Malaysia (BNM), aims to strengthen the prudential framework for banks and financial institutions in the country.

BNM's draft aligns with the Basel's Large Exposure Framework standards but introduces stricter aggregation rules for connected parties and tighter collateral recognition to address Malaysia's high corporate concentration risks.

Malaysia's updated LEL requirements will come into effect as early as 1 June 2026, subject to the finalized policy document.

It will impact:

- Banks and Islamic banks
- Investment banks
- Financial holding companies
- Bank Kerjasama Rakyat Malaysia Berhad

> "The LEL requirements are the foundation of responsible banking. This is an opportunity to enhance resilience, sharpen risk management and demonstrate leadership in an evolving regulatory environment.

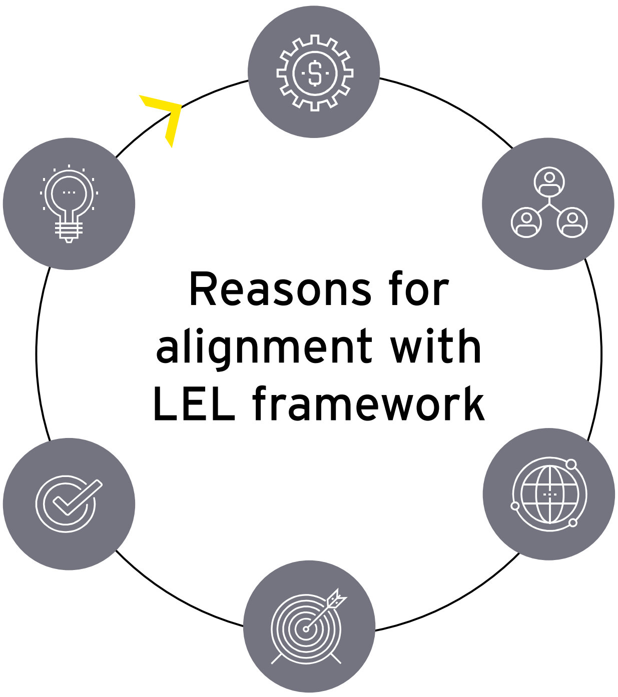
Dato' Megat Iskandar Shah
Malaysia Deputy Assurance Leader,
Ernst & Young PLT

Five key considerations in the ED

1. Clear definition for exposures and connected counterparties.
2. Introduces prudential limits and thresholds.
3. Scope and treatment of exposures to a single or connected counterparty.
4. Requirements for managing/ monitoring of exposures.
5. Requirements for ongoing compliance with LEL.

Reducing risks through responsible banking

A large exposures framework aims to act as a backstop to risk-based capital requirements so that risks arising from large exposures to counterparties are always within a prudent limit. By complying, banking institutions are also assured of the following:



Avoid financial losses

Adhering to LEL can prevent significant losses should a large counterparty defaults as well as ensuring exposures do not exceed the regulatory limits can safeguard the bank's solvency and capital adequacy.

Lower capital requirements

Adopting LEL can maintain profitability and limit lending capacity. As exceeding regulator limits may lead to regulators demanding higher capital buffers to offset the risk from excessive exposures.

Prevent reputational damage

Adhering to regulatory limits can solidify stakeholder confidence, including investors, customers and counterparties. Breaches may lead to funding difficulties or withdrawals.

Reduces funding concentration risk

Placing limits on exposures to individual counterparties reduces the bank's reliance on a few large depositors or selected funding sources. This encourages banks to diversify funding sources that also aligns with liquidity risk management.

Minimize systemic risk contribution

Overexposure to a single counterparty can amplify systemic risk, especially among Global Systemically Important Banks (G-SIBs). Limiting exposure in turn reduces possible contagion effects in the financial system.

Exceptional cases

Due to exceptional circumstances, a bank may exceed the limit. In this case, immediate reporting to the regulator is required, along with ongoing monitoring by the regulator. The bank must present a plan for a timely return to compliance to the regulator.

Snapshot: Key changes in the exposure draft

The ED builds on the existing Single Counterparty Exposure Limit policy document (SCEL PD), which was issued by BNM in 2014, with key changes in the following focus areas.

Shifting capital base **Total Capital** → **Tier 1 Capital**

10% Additional limit are permitted to TNB and PETRONAS as their respective connected counterparties for climate related exposures.[1]

Change of single counterparty threshold from **10% of Total Capital to 5% Tier 1 Capital**

Eligible CRM techniques allowed under the SACR standardized rule.

Calculation and recognition of exposure to trading book exposures are now detailed.

Exclusion and inclusion rules for investment account exposures are now listed.

Note: [1]Subject to the conditions and requirements of the finalized policy document.

Case study: Large exposure treatment and supervision across jurisdictions

Case study #1

The substitution confusion

UK financial firms faced several challenges in applying the mandatory substitution rule (2021), which required shifting exposure from a counterparty to a collateral or protection provider. Concerns were raised over inconsistent interpretations across different types of CRM, such as funded vs. unfunded protections and across products like derivatives and securities financing transactions.

The lack of clear regulatory guidance led to operational inefficiencies, forcing banks to overhaul their reporting systems. Some had to track both original and substituted exposures separately, increasing compliance costs.

Key lesson: Banks must develop internal guidelines to maintain consistent application of substitution rules, document their decision-making and update management information systems to avoid supervisory issues.

Case study #2

The connected client puzzle

Under 2013 regulations, EU banks encountered difficulties in identifying connected clients due to inconsistent application of control and economic interdependence criteria. Cross-holdings and complex corporate structures made it hard to determine which entities should be grouped together for risk assessment.

Additionally, there appeared to be confusion whether CRM treatments should align between capital requirements (RWA) and LEL. This inconsistency created reporting burdens and regulatory uncertainty.

Key lesson: Banks must establish internal guidelines to reassess connected parties, facilitate consistent grouping decisions and reconcile differences in CRM application across regulatory frameworks to maintain compliance.

Sources:

- *PS22/21 – Implementation of Basel Standards: Final rules*, Prudential Regulation Authority (PRA), 2021
- *Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013*, European Banking Authority, 2013

Case study: Large exposure treatment and supervision across jurisdictions

Case study #3

The readiness advantage

Realizing the complexity of the necessary system changes, the Monetary Authority of Singapore (MAS) proactively engaged with banks to understand their operational challenges. Based on constructive industry feedback on technological and procedural upgrades, the authorities wisely extended the effective date for compliance.

Key lesson: Proactive readiness assessments and early engagement with regulators can foster a more effective and efficient implementation process, so that systems are fully prepared to meet the new reforms on time.

Case study #4

The challenge of defining connections

Australian authorized deposit-taking institutions (ADIs) faced complexity when identifying and grouping connected counterparties under banking regulations. The main hurdles included interpreting control relationships under accounting standards, adjusting to new grouping rules and setting practical thresholds for economic interdependence. Some banks relied on subjective judgment, leading to inconsistencies.

Key lesson: Structured internal methodologies can be utilized to determine control and economic interdependence. Clearer documentation and systematic approaches can maintain compliance while minimizing operational disruptions.

These case studies highlight how regulatory ambiguity can create compliance burdens, emphasizing the need for clear internal policies and system adaptability through tailored national regulations and outreach.

Source: Basel Committee on Banking Supervision, Australian Prudential Regulation Authority, 2019

Lessons for the Malaysia market

The ED requirements addresses some of the common challenges faced by other jurisdictions in adopting LEL standards. Set out below are improvements within the ED to complement the existing policy documents for capital adequacy framework on credit risk and exposures to central counterparties.

Area	Challenge	Improvement
Connected client identification	Inconsistent application of control and economic interdependence criteria by EU banking institutions. Institutions in Australia struggled with grouping decisions when it comes to cross-holdings and related parties.	The ED highlights criteria for determining "connected" counterparty, which follow accounting standards for assessing control relationships and conducting interdependence assessments.
Consistency between capital and large exposure	Financial institutions face ambiguity on the alignment for treatment of CRM techniques in accordance with the credit risk weighted assets (CRWA) calculations compared to large exposure measurement. This creates operational and regulatory reporting complexity.	The new ED clearly outlines the minimum requirements and eligibility criteria for CRM techniques.
Substitution approach	Ambiguity on when and how to apply the mandatory substitution approach in the UK across different CRM types and products (e.g., Securities Financing Transactions (SFTs), derivatives).	The new ED principles state that if a position is hedged by credit derivatives, a banking institution must ensure that any reduction in exposure to the original counterparty corresponds to a new exposure to the credit protection provider.
Operational burden and systems overhaul	Implementing the clarified substitution rules in the UK led to challenges in aligning exposure reporting systems with new requirements. This necessitated parallel monitoring of both original counterparty exposures and substituted exposures.	The new ED requires banks to recognize exposure to the CRM provider. Hence, a system adjustment or update is needed to extract the necessary data for the mandatory regulatory reporting.

Next steps

To meet Basel and BNM expectations ahead of the new regulations under the ED, banking institutions can look into the following considerations today.

1. Operationalize control and economic interdependence criteria through standard operating procedure (SOP) enhancement, decision-tree development and documentation reviews for supervisory readiness.

2. Seek legal operations support in reviewing documentation, assessing enforceability of CRM and validating CRM effectiveness under both capital and large exposure treatment.

3. Review and assess readiness for Basel 3 SACR and its correlation and applicability to the latest ED.

4. Deploy digital transformation initiatives that automate exposure tracking and integrates internal management information systems.

How EY teams can help

Regulations under the ED will come into effect on 1 June 2026 and banking institutions will need to act now to help ensure adherence to these changes. Set out below is a customizable approach to help ensure readiness for LEL compliance.

Perform a gap analysis of current operations against the ED requirements.

Perform current state assessment of the bank's current LEL operational processes:

- Review the current policies.
- Conduct interviews with management and staff to understand the existing process.
- Comparative analysis of current operational processes and current policies against the ED requirements.
- Identify gaps and inconsistencies between the existing processes and ED requirements.

Provide recommendations to address gaps.

Key action areas:

- People: Upskilling of employees or addressing resource needs.
- Process: Improve governance or tightening existing processes.
- Technology: Automate or improve the existing digital process.

Implement recommendations.

Based on agreed recommendations and timeline, perform the following:

- Assist with implementing recommendations.
- Rewrite the large exposure limit framework.

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APAC no. 07011442
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