

# MFSA

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MALTA FINANCIAL SERVICES AUTHORITY

**ASSET QUALITY REVIEW  
REQUEST FOR PROPOSAL FOR  
ASSET QUALITY REVIEW  
BANKING BOOK AUDIT**

**January 2014**

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Contacts:

NPMO Lead: Mr Karol Gabarretta (MFSA Banking Supervision Unit)

Significant Banks selected for AQR are:

HSBC Bank Malta plc;

Bank of Valletta plc;

Deutsche Bank (Malta) plc.

## **Introduction: Background and objectives**

The Heads of State or Government of the euro area have announced the establishment of a Single Supervisory Mechanism (SSM), entrusting the European Central Bank (ECB) with responsibility for the supervision of banks in the euro area. Prior to the inception of the SSM, the ECB, together with National Competent Authorities (NCAs), will carry out a comprehensive assessment (CA), including an Asset Quality Review (AQR), of the credit institutions of the participating Member States. The SSM Regulation sets out in Article 33 (4), in conjunction with Article 6 (4), that the CA shall be carried out at least for the significant credit institutions referred to in this document. The AQR, in the form of a risk-based, targeted exercise, will include an analysis of the selected banks' data on relevant credit and securities portfolios and the review of banks' related risk processes. The nature and scope of the exercise will be defined by a methodology devised centrally by the ECB, in close cooperation with NCAs. The AQR will be completed before the SSM assumes supervisory responsibility in November 2014. The methodology referred to above, to which applicants will have to adhere to, prescribes and details the tasks to be performed.

As part of this AQR, the Malta Financial Services Authority (MFSA), in coordination with the ECB will carry out a Banking Book Audit. As most of the activities related to the AQR in Malta are envisaged to be conducted through and with the support of external experts (hereinafter referred to as applicants), the MFSA invites applicants to submit proposals regarding the tasks outlined below. The MFSA envisages that the applicable tasks for the purpose will include the following:

- Applicants would carry out a Data Integrity Validation (DIV) and Loan File Review (LFR), to verify the soundness and validity of the information that banks provide as input to the AQR;
- Applicants would assess the need for changes to impairment provisions on the selected sample of the loan portfolio under the definition and guidelines of the ECB as well as to applicable relevant local legislative requirements (IFRS as endorsed by the EU) so that the consistency across geographies and applicants is ensured;
- Verification of significant credit institutions' collective provisioning levels and methodologies. To support future stress testing exercises, applicants will also review basic risk measures for the portfolio such as observed default rates in accordance with definitions prescribed by the ECB in line with EBA guidelines;
- Applicants would translate any impairment provision adjustments into an estimate of the implied impact for the stated CET 1 capital ratio of the significant entity;
- Applicants would obtain an informed understanding of significant credit institutions' policies and processes, concerning, amongst others, non-performing loan (NPL) management and allocation of collateral values and calculation of LTVs. This review will also consider questions related with the application of rules and policies, such as impairment definitions, identification of forbearance, etc. The Banking Book Audit may extend to other banking book assets.

This Banking Book Audit is expected to commence in early February and shall be concluded by end July 2014.

The latest date for the submission of proposals by applicants is **17.00 hours, 27<sup>th</sup> January, 2014**. Following this date, the MFSA will open a process of Q&A in which the applicants

might be requested to amend part of their proposals or to provide additional information. The tentative period for this Q&A process is between the **30<sup>th</sup> January, 2014 and the 31<sup>st</sup> January, 2014**. The award will be communicated to the applicants and the general public, by not later than the **6<sup>th</sup> February, 2014**.

## **1. Scope of the Banking Book Audit**

The AQR, in general, and thus the Banking Book Audit in particular, are intended to be performed on the range of Significant Credit Institutions (hereinafter referred to as Entities). This list of banks has been defined according to the SSM Regulation (Article 6(4)) and made public by ECB press release dated 23 October 2013. Please note that the number of banks in scope of this exercise may be changed according to the SSM perimeter, to be finalised during 2014.

The AQR's scope extends to all assets in the balance sheet of Entities at the highest level of consolidation within the Eurozone. As such, non-domestic exposures stemming from foreign subsidiaries can be in scope.

The exercise will use 31 December 2013 as the reference date. This date will ensure that the work will be focused on the most recently available accounting and prudential figures.

Not all portfolios may be subject to Loan File Reviews (LFR). Only those portfolios identified by the ECB and the MFSA as being material from a risk perspective will be analysed. For the avoidance of doubt, risk parameters may still be calculated for the wider portfolio to support verification of collective provisioning and as an input for stress testing.

The LFR will be performed on a sample of loans selected from the identified portfolios. The sample will be selected by the applicant in accordance with the guidelines set out by the ECB. The sample will be selected randomly, over-weighting larger and riskier exposures. Nevertheless, it is expected that the sample selected would be made immediately available to the MFSA.

To date, the in scope banks for Malta are:

- HSBC Bank Malta plc;
- Bank of Valletta plc;
- Deutsche Bank (Malta) plc.

## **2. Key tasks of the exercise**

The contracted party will be required to perform the following tasks:

- Data integrity validation on selected portfolios – The contracted party will be required to perform basic data checks on the information provided by the Entities, including but not limited to: completeness (e.g. analyses on empty fields, cross checks between client, collateral and loans for completeness), integrity/validity (e.g. checks on outliers, repetitive patterns in data), consistency (e.g. cross checks within segments, across segments and banks), timeliness (e.g. appraisal dates), assessment of key metrics vs. policy, etc. If required, the contracted party will ensure that loan tapes have been adequately corrected to perform sample selection and will notify the MFSA accordingly;
- Sample selection on selected portfolios – The contracted party, in conjunction with the MFSA, will select from the validated information a sample of customer connections for further analysis. The sample will be selected randomly, though the sample should be over-

weighted with riskier and larger customer connections. The methodology for deciding sampling rates will be provided by the ECB but will be applied by the contracted party and verified by both MFSA and the ECB. It will also be the contracted party's responsibility to coordinate with (any) collateral appraisers that may be appointed by MFSA to carry out a revaluation of the collateral backing the sampled customer connections. Coordination will involve the contracting party providing data on the collateral to the valuer and receiving valuation information back for inclusion in analysis of impairment levels. The contracted party is required to provide regular progress reports on a fortnightly basis to the MFSA in this regard;

- Loan file review and impairment verification on selected sample – The contracted party will perform a review of the classification of the customer connections as guided by applicable EBA Implementing Technical Standards (Standards) around NPLs. For customer connections with evidence of impairment, the contracted party will also assess the appropriate impairment provision in line with applicable accounting standards (e.g. IAS 39) and further specific direction as may be provided by the ECB. Additionally, the following tasks are to be covered as part of the loan file review:

- Identification of forbearance and restructured operations
- Estimation of impairment shortfalls in the exposures reviewed
- Collateral valuation
- Verification of adequacy of provisioning levels;

- Verification and adjustment of collective provisioning models – The contracted party will review the collective provisioning models used by the Entities, ensuring that methodologies, segmentation and parameterisation are in line with market standards and that definitions used are consistent with EBA standards. Where deviations are found, the impact shall be quantified;

- Determination of basic, portfolio level risk parameters (such as observed default rate) – As part of verifying collective provisioning model parameterisation and to act as an input to stress testing analysis, the contracted party will be asked to perform analysis of basic risk parameters such as point in time default rate and cure rate at a sub-portfolio level. The specific parameters to be calculated and the segmentation to be applied will be defined by the ECB;

- Extrapolation and estimating impact on CET1 Capital ratio – The adjustment to specific impairment provisions for the sample will be translated into an overall impact on the relevant sub-portfolio (reflecting skews in the sample). This will then be combined with findings from collective provisioning analysis to arrive at an adjustment to the impairment provisions for the bank balance sheet. This will then be translated into an impact on the CET1 capital ratio reported by the bank according to a schema provided by the ECB. For the avoidance of doubt the contracted party will not be required to validate the CET1 capital ratio calculation;

- Delivering a report describing findings from the review – The report will describe the findings from each element of the above. The report will also include qualitative scoring of relevant bank processes according to a framework set out by the ECB. The MFSA may require specific meetings to be held with the contracted party to discuss the outcome of these reviews;

- Coordinating other external support – the contracted party must take responsibility for coordinating with other 3rd party providers of support such as, real estate appraisal, shipping appraisal, aviation appraisal and other assets appraisal per entity as the need arises.

### **3. Key delivery dates**

This exercise, including the final report shall be concluded by not later than the **31<sup>st</sup> July, 2014**.

### **4. Elements to be included in the proposal document**

Applicants interested in carrying out this mandate should submit a proposal including, at least, the following items:

- Details of the experience in carrying out large scale exercises of this nature in Europe or elsewhere;
- Details of market knowledge in Malta and understanding of historic and current local market conditions;
- Details of the composition and number of the proposed team available for audits (citing relevant experience) together with CVs of the key personnel who will take responsibility for the entire exercise (including compilation of report) during the period between **7<sup>th</sup> February, 2014** and **31<sup>st</sup> July, 2014**;
- A detailed project plan as to how the applicant proposes to undertake the exercise holistically;
- A methodology statement setting out details of how it will be ensured that the timetable is met, including any fall back procedures, and the quality assurance process that will be proposed to be in place;
- The ability of applicants to provide reports in phases prior to the deadline;
- Details of applicable terms and conditions;
- A schedule of proposed rates per hour /per file (based on the average number of man hours it would take to review a file);
- An explanation of how the results of the review would be delivered;
- Full disclosure as to how any conflicts of interest in accordance to the terms described in the Appendix 1 will be managed or eliminated;
- Full disclosure as to how confidentiality would be safeguarded.

The selected external party/parties would, for the purposes of this exercise, be appointed as inspectors in terms of Article 22 of the Banking Act and would be bound by the relevant provisions of the Banking Act (specifically Article 34 of the said Act) and the Professional Secrecy Act.

## 5. Next steps and contacts

Latest date for the submission of proposals by applicants is **17.00 hours of the 27<sup>th</sup> January, 2014.**

The Authority is prepared to consider any reservations or limitations made by the applicant in its proposal.

The final decision will be communicated to the applicants and the general public by not later than the 6th February, 2014.

All the elements included in this Request for Proposal, such as proposals, reports, results, etc. will be disclosed to the ECB and to any other experts acting as the latter's agents. The contact person at the MFSA is Mr Karol Gabarretta (NPMO Lead), while the National Steering Committee (NSC) Chairman is Profs Joseph Bannister.

## 6. Selection Criteria to be applied by MFSA

<b>CRITERIA</b>	<b>RECOMMENDED WEIGHTING</b>	<b>KEY CONSIDERATIONS</b>
<b>Plan of Approach</b>	<b>45%</b>	<ul style="list-style-type: none"><li>• Understanding and meeting of business needs by the applicant.</li><li>• The methodology of approach the applicant proposes to use to deliver the required services on time, efficiently and to the highest standard.</li><li>• References with respect to Asset Quality Review for regulatory and / or supervisory authorities.</li></ul>
<b>Pricing/Cost</b>	<b>30%</b>	
<b>Quality of Team</b>	<b>20%</b>	<ul style="list-style-type: none"><li>• The professional and international capabilities/ expertise of each member of the team including relevant market experience in SSM countries/ Europe.</li><li>• Capacity to guarantee continuity and act as a team with NCA throughout AQR exercise.</li><li>• Details of relevant contracts including past experiences undertaken by the proposed team.</li></ul>
<b>Extension of activities to other asset classes</b>	<b>5%</b>	<ul style="list-style-type: none"><li>• In what way does the applicant intend to deliver the services for other asset classes on time, efficiently, to the highest standard and in an integrated manner.</li><li>• Single firm providing all the services or demonstrating strong ability to lead and manage a group of suitably</li></ul>

		experienced experts.
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Selection of the applicant shall be effected in accordance with the weighting specified in the table above.

## **7. Deliverables**

The final deliverables within the report to be submitted by the contracted party shall include, at least, the following components:

- Introduction and context;
- Scope of the work and purpose of the report;
- Main limitations to the analysis;
- Methodology used and assumptions made;
- Banking book overview;
- Summary of findings;
- Detailed results for each one of the possible tasks enumerated above.

Results of quantitative analyses will be presented in a homogenized manner, i.e. pre-defined templates will be delivered by the ECB that will be used to feedback results.

The contracted party is expected to provide interim reports to the NPMO (email: kgabarretta@mfsa.com.mt) and to ECB if requested:

- At least every two weeks, a report shall be submitted on the progress of the work and compliance with the scheduled deadlines;
- The contracted party will need to be available to discuss interim results on specific cases both locally and abroad with the NPMO and/or the ECB (and their representatives).

All the intermediate and final deliverables have to be submitted in English.

***The contracted party shall be bound by the contractual obligations that will be published on the MFSA website.***

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**National Project Management Office  
c/o Banking Supervision Unit  
Malta Financial Services Authority**



## **Appendix 1: Conflicts of interest**

The MFSA is duty bound to adhere to the highest possible standards to avoid conflicts of interest. As such, in the context of this Banking Book Audit, the MFSA will review and analyse these potential conflicts of interest as a key element for the selection of the applicant. The conflicts of interest can be either absolute or partial. Applicants are expected to report both, and in the case of the latter, explain how they plan to mitigate them. Additionally, applicants will be required to explain how they will avoid potential upcoming conflicts of interest.

Absolute conflicts of interest - There shall be presumed to be a conflict of interest if:

- The applicant has provided any of the Entities with auditing services in either of the past two financial years or is engaged to do so in 2014;
- The applicant is involved in any cause of absolute incompatibility or recusal according to the professional deontological codes;
- The applicant considers that a cause of absolute conflict of interest applies, following its internal codes and ethics.

Partial conflicts of interest – A potential partial conflict of interest may exist if:

- The applicant's subsidiaries or affiliates are held in any of the absolute conflicts of interest described above;
- The applicant, its subsidiaries or affiliates have had, during the past two financial years, or have on-going business relationships with any of the Entities;
- The applicant, its subsidiaries or affiliates are involved in any cause of partial incompatibility or recusal according to the professional deontological codes;
- The applicant considers that a cause of partial conflict of interest applies, following its internal codes and ethics;
- An individual member of the team proposed for this engagement is held in any of the causes of conflict of interest, either absolute or partial, acting as an individual professional or under the on-going professional relationship with the applicant, or past professional relationships with other service providers.

In order to avoid conflicts of interest, applicants are required to submit, at least, the following information:

- A list of the Entities with which the applicant has conflicts of interest, either absolute or partial, according to any of the causes described above. This list should contain enough detail about the nature, scope, parties involved and timeframe of the mandate;
- A description of how the applicant intends to mitigate existing partial conflicts of interest, considering alternatives such as those included in the following illustrative and non-exhaustive list: Ensure that there are strict Chinese walls around the execution team; Give the

MFSA the option to recuse individual members of the team based on their past professional relationships with any of the Entities; Ensure the highest confidentiality standards.

- A description of how the applicant plans to avoid potential conflicts of interests arising during the timeframe of this mandate and six months after it, at least until the results of the AQR are put into the public domain. The following illustrative and non-exhaustive list includes some of the options that could be considered: Routinely conduct conflict checks; Establish internal control process to ensure that upcoming engagements are not conflicted with this one; Inform the MFSA promptly if any potential conflict of interest emerges and agree with the MFSA the subsequent course of action; Restrict the nature and scope of upcoming engagements during the timeframe of this mandate; Ensure that any subcontractor will respect the same conditions.
- Should the applicant have a (potential) conflict of interest and should the applicant not be able to prove that it has safeguarded that this will not in any way have any adverse effect on the delivery of the services, this may lead to either the limitation of the scope of the mandate or the exclusion of the applicant.