MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular to the investment services industry regarding the Fourth Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) – Known together as the CRD IV Package

The purpose of this circular is to provide the investment services industry with an update on the regulatory developments relating to the capital adequacy of investment firms.

This circular is divided into the following five sections:

Section 1 provides an overview of the legislative framework.

Section 2 outlines the new measures that are proposed in the revised Capital Requirements Directive.

Section 3 explains the main changes that are proposed through the Capital Requirements Regulation.

Section 4 deals with the implementation of the uniform reporting templates.

Section 5 includes the list of persons within the Securities and Markets Supervision Unit who may be contacted for the purpose of any clarifications on this circular.

The MFSA encourages the investment services industry to familiarise itself with the CRD IV Package, as this will have an impact on their business and compliance procedures.

The CRD IV Package is subject to the co-legislative procedure (i.e. the legislative proposal of the European Commission is presented to the EU Council and the European Parliament for their joint approval). The European Commission, the EU Council and the European Parliament are still undergoing discussions on these proposals. The Securities and Markets Supervision Unit has been participating in these negotiations and has been insisting on the application of the proportionality principle with regards to the applicability of all the new proposed requirements to investment firms.

This document contains a number of hyperlinks to the EU institutions' proposed legislative text and to relevant communications issued by the European Banking Authority (EBA), which are highlighted in blue and are underlined.

1. Background

On the 23rd February and the 2nd March 2010, the Authority brought to the attention of investment services licence holders proposed changes by the European Commission to Directive 2006/48/EC and 2006/49/EC [the current Capital Requirements Directive].

The latest European Commission's proposal on the CRD IV Package was adopted on the 20th July 2011. This proposed the replacement of the current Capital Requirements Directive with two legislative instruments: the Fourth Capital Requirements Directive (the Directive) and the Capital Requirements Regulation (CRR). The objective of this legislative package is to strengthen the prudential regulation of financial institutions. These proposals also have the purpose of implementing the revised capital adequacy standards agreed by the Basel Committee on Banking Supervision [i.e. the Basel III standards].

2. The Proposed Directive

Areas which require transposition by Member States in their national laws are covered in the proposed Directive. The Directive will be applicable to both credit institutions and investment firms and will empower competent authorities with new supervisory tools, for the purpose of enhancing their prudential supervision. The following is an outline of the new measures that are being proposed in the Directive.

2.1 Sanctions

The Directive attempts to reinforce the sanctioning regime of Member States with the aim of ensuring effective supervision and promoting a level playing field. Examples of administrative sanctions which are introduced in the proposed Directive include the imposition of an administrative fine of up to 10% of the institution's annual total turnover and a temporary ban against members of the institution, who are responsible for effectively directing the business of the institution.

2.2 Governance arrangements

In order to strengthen corporate governance principles, the Directive introduces new rules applicable to persons who effectively direct the business of the institution, who shall be required to oversee the functions of senior management and the implementation of the institution's strategic objectives, risk strategy and internal governance. When performing the review of the institution's internal capital and adequacy assessment process, it is the competent authorities' role to ensure that the governance arrangements of institutions are adequate to cover their risk exposures.

2.3 Enhanced supervision

The supervisory tasks of competent authorities are further reinforced through the proposed implementation of an annual supervisory examination programme for the supervised institutions, which shall indicate the types of institutions that will be subject to enhanced supervision, for instance by increasing the number or frequency of the on-site visits to the institutions.

2.4 Capital Buffers

The European Commission's proposal of the 20th July 2011 introduces two capital buffers in addition to the capital requirement of 8%: **[i]** a capital conservation buffer; and **[ii]** a countercyclical capital buffer. The objective of the capital conservation buffer is to enable institutions to build up capital in good economic times in order to cater for unexpected losses in periods of financial distress. The countercyclical capital buffer is intended for those institutions that are involved in providing credit in order to cater for the risk of excessive credit growth, which may lead to the build-up of systemic risk.

An amount of 2.5% of risk weighted assets shall be held by institutions in the form of Common Equity Tier 1 capital [currently referred to as Core Tier One Capital] for the purpose of meeting the capital conservation buffer requirement. Institutions may however need to increase their Common Equity Tier 1 capital by an additional amount of up to 2.5% of risk weighted assets depending on where their credit exposures are located, for the purpose of meeting the countercyclical capital buffer requirement. Where justified, the ceiling of 2.5% may also be exceeded. Institutions which do not meet the capital buffers will be subject to restrictions on the distribution of profits and will be required to prepare a capital conservation plan. The capital conservation plan will include the measures that shall be applied by institutions to increase their own funds.

The EU institutions are proposing 1st January 2016 as the date of applicability of the capital buffers, providing Member States with the possibility to exercise the following transitional provisions:

Transitional provisions	**Conservation Buffer**	**Countercyclical Buffer**
1st January 2016 to 31st December 2016	>=0.625%	<= 0.625%
1st January 2017 to 31st December 2017	>=1.25%	<=1.25%
1st January 2018 to 31st December 2018	>=1.875%	<=1.875%

Whilst the European Commission is of the view that capital buffers shall be applicable to both credit institutions and investment firms, the EU Council's proposal of the 11th May 2012 provides Member States with the option to exempt small and medium investment firms from these requirements as long as they do not pose a threat to the financial stability of the Member State concerned. Investment firms shall be categorised as small and medium in accordance with Article 2 of the Annex to the EU Recommendation 2003/361. On the other hand, the European Parliament's proposal of the 30th May 2012, generally exempts investment firms that are not authorised to deal on own account or underwrite/place financial instruments on a firm commitment basis from the application of the capital buffers [i.e. Category 2 Investment Services Licence Holders which are not involved in the provision of collective portfolio management, in the case of Malta]

Divergent views of the EU institutions also exist with respect to the proposed transposition deadline of the Directive. Whilst the European Commission and the EU Council proposed 31st December 2012 as the transposition deadline of the Directive, the European Parliament suggested 31st December 2013 as an alternative transposition date. This notwithstanding, all proposals are currently still in draft form and require the joint approval of the European Parliament and the EU Council as Level 1 text.

3. The Proposed CRR

The EU's objective of achieving maximum harmonisation in relation to the prudential rules applicable to credit institutions and investment firms and the need to establish a 'European Single Rule Book' have been the driving force of setting out the prudential requirements in the form of a Regulation. Whilst the current Capital Requirements Directive already contained harmonised rules, the European Commission's proposal removes national options and discretions from these Directives and therefore eliminates significant divergences in national rules through the legal structure of a Regulation. The proposed CRR will be directly applicable to credit institutions and investment firms, and in contrast to the Directive, it does not require transposition into local legislation. The following is an explanation of the main changes being proposed through the CRR.

3.1 Definition of 'Investment Firms'

Article 4 (8) of the proposed CRR contains a definition of 'investment firms' which determines the extent of applicability of the Regulation to these firms. Under the definition, firms which are only authorised to provide the service of investment advice or reception and transmission of orders without holding clients' money and assets will be excluded from the definition of 'investment firms' and, in principle, will not be covered by the provisions of the CRR. These types of firms (i.e. Category 1 Investment Services Licence Holders in the case of Malta) will only be subject to an initial capital requirement of €50,000.

In addition to the above exemption, the European Parliament and the EU Council are also proposing to exclude investment firms that are only authorised to provide the service of individual portfolio management within the meaning of Directive 2004/39/EC (the Markets in Financial Instruments Directive), and which are not holding clients' money and securities, from the definition of 'investment firms'. In the case of Malta, these types of firms include Category 2 Investment Services Licence Holders.

If the European Parliament and EU Council's proposal is approved, Category 2 Investment Services Licence Holders which are only licensed to provide individual portfolio management and which are not allowed to hold clients' money and assets, will only be subject to an initial capital requirement of €50,000.

3.2 Liquidity

EU institutions are proposing to introduce a regulatory framework on liquidity, with the objective to harmonise the liquidity requirements in 2015. These requirements will be applicable to investment firms that are involved in dealing on own account or in underwriting/placing of financial instruments on a firm commitment basis [i.e. to Category 3 Investment Services Licence Holders in the case of Malta]. Investment firms which form part of an Investment Services Consolidation Group may be required to comply with the requirements relating to liquidity on a consolidated basis.

This notwithstanding, in terms of the proposed CRR, the European Commission, in consultation with the EBA, is required to provide its opinion to the European Parliament and the EU Council by 31st December 2014 on whether and how the liquidity requirements shall apply to investment firms. Until the European Commission's opinion is issued, the EU Council is providing competent authorities with the option to exempt investment firms from the liquidity requirements, by taking into account the nature, scale and complexity of the investment firms' activities.

The EU proposals on liquidity aim to achieve two separate but complementary objectives by requiring institutions to calculate the liquidity coverage requirement and the net stable funding requirement. The objective of the liquidity coverage requirement is to ensure that institutions have sufficient liquid assets to match the net liquidity outflows during a period of liquidity stress over a short period of time.

Until the liquidity coverage requirement is implemented as a binding requirement, institutions are required to report the items relating to the calculation of the liquidity coverage requirement to the relevant competent authority for monitoring purposes. The net stable funding requirement has a long-term objective by requiring institutions to ensure that their assets are funded with stable sources of funding as a minimum over a one year period, or a period of more than one year. The reporting requirement of the net stable funding requirement is set to quarterly, in contrast to a monthly reporting requirement for the liquidity coverage requirement.

3.2 Leverage

In order to prevent institutions from taking on excessive leverage risk, the European Commission is introducing a non-risk based measure, which is being referred to as the leverage ratio. The calculation of the leverage ratio is expressed as a percentage by dividing the institution's Tier 1 capital with the institution's exposure values of its assets and off-balance sheet items.

It is expected that the leverage ratio will become a binding requirement in 2018 and that institutions will be required to report this calculation on a quarterly basis to the competent authority, which may, upon request, submit this information to EBA for the purpose of its review on whether the leverage ratio is an appropriate tool for limiting the risk of excessive leverage. It is envisaged that institutions, which are subject to consolidation, will also be required to calculate the leverage ratio on a consolidated basis.

The European Commission is proposing to apply the calculation of the leverage ratio to all types of investment firms. The EU Council, in contrast to the European Commission, is of the view that the leverage ratio should be calculated by investment firms that are involved in dealing on own account or in underwriting or placing of financial instruments on a firm commitment basis [i.e. to Category 3 Investment Services Licence Holders in the case of Malta].

On the other hand, the European Parliament is introducing a different concept which relates to the application of a differentiated leverage ratio (i.e. a leverage ratio which is appropriate for the different types of institutions, which are involved in different business activities and employ different business models). This proposal entrusts EBA with the responsibility to identify and assign the institutions' business models into different categories of risks, and to report its results to the European Commission.

3.3 Own Funds

EU institutions are proposing to amend the meaning of own funds for the purpose of calculating the capital requirement, by:

[i] eliminating Tier 3 capital from the definition of own funds; and

[ii] introducing new meaning and terminology for Tier 1 capital, which shall consist of the sum of Common Equity Tier 1 capital and Additional Tier 1 capital.

Institutions will still be required to hold at all times a capital requirement of 8%, which must however satisfy the new thresholds of 4.5% of Common Equity Tier 1 capital and a total of 6% of Tier 1 capital.

In order to assist institutions with the implementation of the increased own funds requirements, the European Commission and the EU Council are proposing to apply lower thresholds for Common Equity Tier 1 capital and total Tier 1 capital during the years 2013 and 2014, as indicated in the following table.

Transitional provisions	**Common Equity Tier 1 capital**	**Tier 1 capital**
1st January 2013 to 31st December 2013	Greater than or equal to 3.5% but not exceeding 4.5%	Greater than or equal to 4.5% but not exceeding 6%
1st January 2014 to 31st December 2014	Greater than or equal to 4% but not exceeding 4.5%	Greater than or equal to 5.5% but not exceeding 6%

The European Parliament does not agree with this proposal and is of the view that institutions should not be subject to any transitional provisions in this regard. These thresholds are still however subject to the EU negotiations process.

4. The implementation of the common reporting framework (COREP)

4.1 Background

As a result of the extensive rise in cross-border activity amongst EU member states, the EBA has introduced a common reporting framework under the Capital Requirements Directive. Whilst the predecessor of EBA, the Committee of European Banking Supervisors started working on a common reporting framework in July 2004, the Second Capital Requirements Directive (CRD II) required the implementation of the COREP templates as from 31st December 2012.[1] In this regard, during 2010 and 2011, the EBA ensured that the COREP templates reflected the amendments arising from the implementation of CRD II and the third Capital Requirements Directive (CRD III). Due to the updates in the CRD IV Package, EBA has continued to develop further the COREP templates and has issued a Consultation Paper on the draft ITS relating to the supervisory reporting requirements for institutions in December 2011.

4.2 Practical implementation

The MFSA's Securities and Markets Supervision Unit is at present preparing the necessary foundation work for the implementation of the COREP templates. The COREP framework will consist of a set of eight templates which are detailed in the following table:

COREP Templates	**Description**
Capital Adequacy	These templates provide an overview of the calculation relating to the institution's capital requirement.
Group Solvency	Institutions subject to supervision on a consolidated basis shall semi-annually report information on the entities included in the scope of consolidation.
Credit Risk	A detailed account of the credit risk exposure of the institution is provided in these templates.
Operational Risk	The operational risk component is calculated in these templates.
Market Risk	The market risk templates relate to the calculation of the position risk component (including the specific risk factor and the general risk factor of the position risk component) of traded debt instruments and equities, the foreign exchange risk component, and the commodities instruments risk component. Market risk exposures which are calculated using the institution's own internal risk-management model are also featured within these templates.
Large Exposures	The data relating to the institution's large exposures to individual counterparties or group of connected clients is provided in this

[1] The Omnibus Directive (Directive 2010/78/EU) indicated that EBA shall develop draft implementing technical standards (ITS) to introduce uniform formats, frequencies and dates of reporting. As a result, the implementation date of 31st December 2012 was superseded.

	template.
Liquidity	The items relating to the calculation of the liquidity coverage requirement and the net stable funding requirement are reported in the liquidity templates.
Leverage	The leverage template provides a detailed account of the leverage ratio calculation.

During the years 2011 and 2012, EBA issued four consultation papers, with the aim to specify the uniform formats, frequencies and dates of prudential reporting relating to the COREP templates. These include:

[i] EBA Consultation Paper on draft ITS on Supervisory reporting requirements for institutions with respect to capital adequacy, group solvency, credit risk, operational risk and market risk;

[ii] EBA Consultation Paper on Draft ITS on Supervisory reporting requirements for large exposures;

[iii] EBA Consultation Paper on Draft ITS on Supervisory reporting requirements for liquidity coverage and stable funding; and

[iv] EBA Consultation Paper on Draft ITS on Supervisory reporting requirements for leverage ratio.

On the 31st July 2012, EBA advised that the ITS cannot be finalised until the CRR is adopted by the EU Council and the European Parliament and that the phase-in of the COREP reporting requirements may be considered as an alternative to an implementation of all the COREP reporting templates on the same date. An example relating to the implementation of the phase-in reporting requirements was provided with respect to three different scenarios, relating to adoption date of the CRR being either 1st January 2013 or 30th June 2013 or 31st December 2013. Once the CRR is approved, EBA is planning to take six weeks in order to submit the final ITS to the European Commission for endorsement.

EBA provided further updates, through its communication of the 29th August 2012, indicating that certain amendments have been effected to the COREP templates. On the 20th December 2012, EBA issued its latest position regarding the supervisory requirements for liquidity and leverage and envisaged that the first remittance dates will likely fall in the first quarter of the year 2014.

The implementation of the COREP framework will have a direct impact on Maltese Investment Services Licence Holders (in particular, Category 2 and Category 3 Licence Holders).

The MFSA's Securities and Markets Supervision Unit is currently working on the new reporting templates relating to the implementation of the COREP framework and is aiming to automate, to the extent possible, the new financial returns. Category 2 and Category 3 Investment Services Licence Holders will be required to use the new financial returns, which are subject to the EU supervisory reporting requirements, and which will include new calculation requirements arising from the adoption of the CRR.

Investment Services Licence Holders are advised to familiarise themselves with the draft COREP templates by referring to the four EBA consultation papers that are mentioned in this circular.

5. Contacts

Any queries or requests for clarifications in respect of the applicability of the Directive and the CRR to investment firms should be addressed to: Mr. Christopher P. Buttigieg, Deputy Director, Securities and Markets Supervision Unit Tel: 25485229 or by e-mail on cbuttigieg@mfsa.com.mt or Ms. Mellyora Grech, Analyst, Securities and Markets Supervision Unit Tel: 25485193 or by e-mail on mgrech@mfsa.com.mt**.**

Any queries in relation to the implementation of COREP to investment firms should be sent directly to Mr. Andrew Said, Analyst, Securities and Markets Supervision Unit by email on asaid@mfsa.com.mt.

Communications Unit
Malta Financial Services Authority
10th January 2013