TECHNICAL CRITERIA ON ORGANISATION AND TREATMENT OF RISKS

1. GOVERNANCE

Arrangements shall be defined by the Board of Directors of a credit institution concerning the segregation of duties in the organisation and the prevention of conflicts of interest.

2. TREATMENT OF RISKS

The Board of Directors of a credit institution shall approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks that the credit institution is, or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

3. CREDIT AND COUNTERPARTY RISK

a. Credit-granting shall be based on sound and well-defined criteria. The process for approving, amending, renewing, and re-financing credits shall be clearly established.

b. The ongoing administration and monitoring of their various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, shall be operated through effective systems.

c. Diversification of credit portfolios shall be adequate, given the credit institution's target markets and overall credit strategy.

d. Credit institutions engaged in foreign currency lending may be exposed to indirect exchange risk as a component of credit risk though currency mismatches on their customers' balance sheets. To this effect, credit institutions are expected to apply the principles found in MFSA Rule 01/2012 – Foreign Currency Lending Rule[(1)] through the implementation of appropriate and apposite internal risk management and governance frameworks.

4. RESIDUAL RISK

The risk that recognised credit risk mitigation techniques used by the credit institution prove less effective than expected shall be addressed and controlled by means of written policies and procedures.

(1) Available at http://www.mfsa.com.mt/Files/LegislationRegulation/regulation/MFSA/20121212%20-%20FX%20Lending%20Rule.pdf

5. CONCENTRATION RISK

The concentration risk arising from exposures to counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques and including, in particular, risks associated with large indirect credit exposures (e.g. to a single collateral issuer), shall be addressed and controlled by means of written policies and procedures. Such written policies and procedures should include any limits as may be set out by the credit institution in terms of paragraph 24 to Banking Rule BR/02.

6. SECURITISATION RISKS

a. The risks arising from securitisation transactions in relation to which the credit institutions are investor, originator or sponsor, including reputational risks (such as a rise in relation to complex structures or products) shall be evaluated and addressed through appropriate policies and procedures, to ensure in particular that the economic substance of the transaction is fully reflected in the risk assessment and management decisions.

b. Liquidity plans to address the implications of both scheduled and early amortization shall exist at credit institutions which are originators of revolving securitisation transactions involving early amortisation provisions.

7. MARKET RISK

Policies and processes for the measurement and management of all material sources and effects of market risks shall be implemented.

8. INTEREST RATE RISK ARISING FROM NON-TRADING ACTIVITIES

Systems shall be implemented to evaluate and manage the risk arising from potential changes in interest rates as they affect a credit institution’s non-trading activities.

9. OPERATIONAL RISK

a. Policies and processes to evaluate and manage the exposure to operational risk, including to low-frequency high-severity events, shall be implemented. Without prejudice to the definition of operational risk as laid down in Article 4(22) of EU Directive 2006/48/EC, credit institutions shall articulate what constitutes operational risk for the purposes of those policies and procedures.

b. Contingency and business continuity plans shall be in place to ensure a credit institution’s ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

10. LIQUIDITY RISK

a. Robust strategies, policies, processes and systems shall exist for the identification, measurement, management and monitoring of liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that credit institutions maintain adequate levels of liquidity buffers. Those strategies, policies, processes and systems shall be tailored to business lines, currencies and entities and shall include adequate allocation mechanisms of liquidity costs, benefits and risks.

b. The strategies, policies, processes and systems referred to in paragraph 10a shall be proportionate to the complexity, risk profile, scope of operation of the credit institution and risk tolerance set by the board of directors and reflect the credit institution's importance in each Member State, in which it carries on business. Credit institutions shall communicate risk tolerance to all relevant business lines.

c. Credit institutions shall develop methodologies for the identification, measurement, management and monitoring of funding positions. Those methodologies shall include the current and projected material cash-flows in and arising from assets, liabilities, off-balance sheet items, including contingent liabilities and the possible impact of reputational risk.

d. Credit institutions shall distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. They shall also take into account the legal entity in which assets reside, the country where assets are legally recorded either in a register or in an account as well as their eligibility and shall monitor how assets can be mobilised in a timely manner.

e. Credit institutions shall also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the EEA.

f. A credit institution shall consider different liquidity risk mitigation tools, including a system of limits and liquidity buffers in order to be able to withstand a range of different stress events and an adequately diversified funding structure and access to funding sources. Those arrangements shall be reviewed regularly.

g. Alternative scenarios on liquidity positions and on risk mitigants shall be considered and the assumptions underlying decisions concerning the funding position shall be reviewed regularly. For these purposes, alternative scenarios shall address, in particular, off-balance sheet items and other contingent liabilities, including those of SSPEs or other special purpose entities, in relation to which the credit institution acts as sponsor or provides material liquidity support.

h. Credit institutions shall consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time horizons and varying degrees of stressed conditions shall be considered.

i. Credit institutions shall adjust their strategies, internal policies and limits on liquidity risk and develop effective contingency plans, taking into account the outcome of the alternative scenarios referred to in paragraph 10g.

j. In order to deal with liquidity crises, credit institutions shall have in place contingency plans setting out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls. Those plans shall be regularly tested, updated on the basis of the outcome of the alternative scenarios set out in paragraph 10g, be reported to and approved by senior management, so that internal policies and processes can be adjusted accordingly.

k. The Authority recognises that the US Dollar has proven to be a material funding currency for certain credit institutions, and throughout the past years, there have been on-going strains in the US Dollar funding markets. These strains may create key direct potential system-wide risks, in particular material maturity mismatches between the US Dollar assets and liabilities of a credit institution, where short-term funding is used to finance longer term assets in the said currency.

l. Accordingly, the Authority requires credit institutions, particularly those which utilise the US Dollar as a material funding currency for their operations, to apply the provisions of MFSA Rule 02/2012 on US Dollar Funding[(2)] which outlines the general principles regulating US Dollar denominated funding.

11. REMUNERATION POLICIES

a. When establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, credit institutions shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities:

   (i) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the credit institution;

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(2) Available at http://www.mfsa.com.mt/Files/LegislationRegulation/regulation/MFSA/2%20of%202012%20US%20Dollar%20Funding%20Rule.pdf

(ii) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest;

(iii) the Board of Directors of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation;

(iv) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the Board of Directors;

(v) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

(vi) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in point 11(b) or, if such a committee has not been established, by the Board of Directors;

(vii) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individual performance, financial and non-financial criteria are taken into account;

(viii) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

(ix) the total variable remuneration does not limit the ability of the credit institution to strengthen its capital base;

(x) guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment;

(xi) in the case of credit institutions that benefit from exceptional government intervention:

(1) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;

(2) the Authority requires credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the persons who effectively direct the business of the credit institution within the meaning of Article 7(1)(b) and (c) of the Act;

(3) no variable remuneration is paid to the persons who effectively direct the business of the credit institution within the meaning of Article 7(1)(b) and (c) of the Act, unless justified;

(xii) fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component.

Credit institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration;

(xiii) payments related to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure;

(xiv) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required.

The allocation of the variable remuneration components within the credit institution shall also take into account all types of current and future risks;

(xv) a substantial portion, and in any event at least 50%, of any variable remuneration shall consist of an appropriate balance of:

(1) shares or equivalent ownership interests, subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in case of a non-listed credit institution, and

(2) where appropriate, other instruments within the meaning of paragraph 12 of Banking Rule BR/03, that adequately reflect the credit quality of the credit institution as a going concern.

The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the credit institution. The Authority may place

restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (xvi) and the portion of the variable remuneration component not deferred;

(xvi) a substantial portion, and in any event at least 40%, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.

Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60% of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

(xvii) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the credit institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;

(xviii) the pension policy is in line with the business strategy, objectives, values and long-term interests of the credit institution.

If the employee leaves the credit institution before retirement, discretionary pension benefits shall be held by the credit institution for a period of five years in the form of instruments referred to in point (xv). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (xv) subject to a five-year retention period;

(xix) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

(xx) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of the Act, Rules or the CRD.

The principles set out in this point shall be applied by credit institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

b. Credit institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgement on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the Board of Directors. The Chairperson and the members of the remuneration committee shall be non-executive members of the Board of Directors. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.

c. Transitional Provision:

Credit institutions shall be required to apply the principles laid down herein to:

(i) remuneration due on basis of contracts concluded before 30th December 2010 and awarded or paid after that date; and

(ii) for services provided in 2010, remuneration awarded, but not yet paid, before 30th December 2010.