MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

BANKING RULES

THE SUPERVISORY REVIEW PROCESS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

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INTRODUCTION

1. In terms of Article 4 of the Banking Act 1994 (the Act) the Competent Authority (the Authority) as appointed under Article 3(1) of the Act is empowered to make Banking Rules as may be required for carrying out any of the provisions of the Act. The Authority may also amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to credit institutions and the Authority shall make copies thereof available to the public.

2. The Supervisory Review Process of Credit Institutions Authorised under the Banking Act 1994 (the Rule) is being made pursuant to Article 17C of the Act. The robustness of a credit institution's internal governance process is invariably an essential component of the institution's internal capital adequacy assessment process (ICAAP) in that it is mainly concerned with setting an institution's business objectives and risk appetite, with how its business is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey and how internal control (including risk control, compliance and internal audit) is organised.

3. Accordingly, while Article 17B of the Act requires every credit institution to put in place robust governance arrangements, Article 17C requires credit institutions to establish their own ICAAP. Furthermore, in accordance with Article 17D, the Authority shall carry out a supervisory review and evaluation process (SREP) over licensed credit institutions. Notwithstanding that, as explained below, the principles underlying the Rule relate both to obligations of credit institutions and also of the Authority, the Authority has deemed that disclosure of its obligations in the Rule would provide licence holders and other stakeholders with information as to how the Authority would undertake its SREP.

SCOPE AND APPLICATION

4. The Rule applies to all credit institutions licensed under the Banking Act 1994.

5. The scope of the Rule is to ensure that credit institutions have sufficient capital to support all material risk which their business exposes them to. To achieve the scope of the Rule within an international context, the Rule is modelled on the requisites of the European Union Directive 2006/48/EC of 14 June 2006 (the CRD). In this context, it should be emphasised that in drafting this document, the Authority has been guided by the Committee of European Bank Supervisors (CEBS) Guidelines on the Application of the Supervisory Review Process (GL 03) issued on 25th January 2006.

6. In accordance with Articles 17(C) and (D) of the Act, the Rule aims to reinforce the link between risk and capital and in this context, four principles (paragraphs 7-10 below) underpin the Rule.

Obligations of Credit Institutions

7. Credit institutions should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

7a. Credit institutions should follow the Guidelines on the management of operational risk in market related activities issued by CEBS and as prescribed in Annex 2I to this Rule. These Guidelines were issued to complement the framework of high-level guidelines with more specific principles and implementation measures for the identification, assessment, control and monitoring of operational risks in market-related activities.

Obligations of the Authority

8. The Authority will review and evaluate credit institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with own funds' requirements. The Authority will take supervisory action if the result of this review process is considered inadequate.

9. The Authority expects credit institutions to operate above the minimum own funds' requirements and would require them to hold capital in excess of the minimum level laid down in Banking Rules BR/04 and BR/08.

10. The Authority will seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular credit institution and will require it to take rapid remedial action if capital is not maintained or restored.

DISCLOSURE AND TRANSPARENCY

11. The key element of the SREP is the dialogue between the Authority and credit institutions. Whilst the ICAAP remains the institution's responsibility, the Authority's SREP will provide information on the way the credit institution is structuring its ICAAP, the assumptions which are used to determine underlying risks, risk sensitivity and confidence levels and how risks are aggregated. In order for credit institutions to have a clear understanding of this approach, the key elements of the SREP framework which the Authority intends to adopt are explained in paragraphs 22-25 and amplified in Annex 3B.

THE CONCEPT OF PROPORTIONALITY

12. As a general principle, the requirements of this Rule would be applied by the Authority in a proportionate manner to reflect the nature, scale and complexity of the activities of the credit institution concerned. The concept of proportionality will therefore have a material influence on the structure and complexity of the institutions' ICAAP, as prescribed in paragraph 16-21, as well as the Authority's SREP mentioned in paragraphs 22-25. While it should be noted that there is, as yet, no generally accepted definition of proportionality, rather, it is a credit institution's responsibility to assess the adequacy of its ICAAP methods, systems and processes, basing itself primarily on the nature (i.e. risk level and complexity) and scale of the institution's business activities. Smaller institutions which mainly engage in relatively low-risk transactions might be able to fulfil the requirements in an appropriate manner using relatively simple methods based on ICAAP principles. For banks which conduct much more complex business activities or handle high transaction volumes, it may be necessary to employ more complex systems in order to meet ICAAP requirements.

INTERNAL GOVERNANCE

13. A credit institution's internal governance arrangements should include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to and adequate internal control mechanisms, including sound administrative and accounting procedures.

14. Internal governance aims at ensuring that an institution's management body (both the Board of Directors and senior management) is explicitly and transparently responsible for its business strategy, organisation and internal control. Internal governance is the responsibility of the Board of Directors of the credit institution. It is concerned mainly with setting the institution's business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organised.

15. The arrangements, processes and mechanisms referred to in paragraphs 13 and 14 above, shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities within the context of the principle of proportionality as mentioned in paragraph 12 above. Credit institutions are also expected to follow the principles on internal governance as issued by the EBA and as prescribed in Appendix 1 to this Rule, albeit within the context of paragraph 12. Furthermore, the technical criteria on Organisation and Treatment of Risks, as prescribed in Annex 2B to this Rule and the Principles for Remuneration Policies and Practices issued by EBA and prescribed in Annex 2E to this Rule are also to be taken into account. Institutions should also note the "Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk" issued by the CEBS on 8th

September 2009 and updated on 27th July 2010 (http://www.eba.europa.eu/documents/10180/16094/Compendium_v2.pdf).

15a. The Authority shall use the information collected in accordance with the criteria for disclosure established in Banking Rule BR/07 Appendix 2 Part 2 paragraph 15(f) to benchmark remuneration trends and practices. The Authority is required to provide the CEBS with that information. Credit institutions shall moreover submit to the Authority information on the number of individuals in pay brackets of at least €1 million including the business area involved and the main elements of salary, bonus, long-term award and pension contribution. The Authority is also required to forward that information to the CEBS, which shall disclose the information on an aggregate home Member State basis in a common reporting format.

INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

16. Within the credit institution's internal governance framework, the ICAAP is a process that the management body (both the Board of Directors and senior management) utilises to ensure that:

- there is adequate identification, measurement, aggregation and monitoring of the institution's risks,
- adequate internal capital is held by the institution in relation to its risk profile, and
- the institution uses sound risk management systems and there is the intention to develop them further.

17. It is the responsibility of the credit institution to define and develop its ICAAP. The credit institution has to demonstrate, during its dialogue with the Authority, that its ICAAP is comprehensive and adequate to address the nature of risks posed by its business activities and its operating environment.

18. Within the ambit of paragraph 12, the framework under which a credit institution should develop its ICAAP is designed to be risk-based. It should emphasise the importance of capital planning, but also the importance of management, and other qualitative aspects of risk management. When assessing their capital needs, all institutions should be able to take into account the impact of economic cycles and sensitivity to other external risks and factors.

19. A credit institution should have systems in place to evaluate and manage the risk arising from potential changes in interest rates as they affect a credit institution's non-trading activities. Moreover, it is the credit institution's responsibility to identify, measure, monitor and control concentration risk, and allocate internal capital where considered necessary. Credit institutions are expected to follow the CEBS technical guidelines on the management of Interest Rate Risk in the Banking Book (issued on 3rd October 2006) and

Concentration Risk (issued on 2nd September 2010) as a follow-up to the CEBS GL03 and as prescribed in Annexes 2F and 2G to this Rule respectively, albeit within the context of paragraph 12.

20. Credit institutions may have already developed various methodologies for assessing their risk exposure and setting capital against it. The introduction of the ICAAP is not meant to suggest that existing methods, which have met the needs of credit institution over the years, necessarily need to be replaced. However, it is a statutory requirement that all institutions should have adequate processes in place.

21. The ICAAP should be embedded in the credit institution's business and organisational processes. Credit institutions are expected to follow general guidelines for an ICAAP framework as issued by CEBS and as prescribed in Appendix 2 to this Rule, albeit within the context of paragraph 12.

STRESS TESTING

21a. One of the most important methodologies within an institution's 'tool-kit' used for the assessment of risks within the ICAAP is the use of stress testing. While an institution would initially calculate its capital requirements under normal circumstances on the basis of its current risks, it is imperative that stress tests, which involve quantitative and qualitative techniques to gauge institutions' vulnerability to exceptional but plausible events are also carried out. Within this context, credit institutions are expected to follow the main Principles underpinning sound stress testing techniques by institutions, as issued by CEBS as Guidelines on 26th August 2010 through GL32. These Guidelines replace those issued by CEBS as CP12 on 14th December 2006. The original Guidelines had been transposed through Annex 2D to this Rule and have now been replaced by the contents of GL32. As with other Principles, those relating to stress testing are also to be applied within the context of paragraph 12 of the same Rule. It is pertinent to note the Principles within GL32 do not only relate to stress testing requirements as part of a credit institution's ICAAP process. Rather, this document also illustrates stress testing as a key risk management tool within financial institutions.

SUPERVISORY REVIEW AND EVALUATION PROCESS

22. In order to evaluate the ICAAP, including the adequacy of capital held by a credit institution, the Authority will review the credit institution's exposure to all material risks (its risk profile), the adequacy and reliability of its internal governance, the adequacy of its own funds and the internal capital mitigants it has set against its risks. The Authority would also assess whether capital alone is the correct means of addressing the institution's vulnerabilities and/or whether new systems, processes and procedures need to be put in place.

23. The SREP would need to be structured with a view to ensuring consistency of treatment by the Authority across credit institutions, while at the same time

keeping in mind that credit institutions differ in risk profile, strategy and management.

24. In general, the Authority assesses the risk profile of a credit institution using a variety of sources (including statistical, desk-based off-site analysis, onsite visits/inspections, and routine relationship management) as part of its risk-based prudential supervision. All these sources should provide the foundation for the Authority to undertake (among other things) an evaluation of the credit institution's risk profile. They should also enable the Authority, if so required, to apply prudential measures over a period it determines, and to maintain an accurate and up-to-date picture of the credit institution's risk profile in light of its progress in implementing prudential measures and/or other events which may have a significant impact on the risk assessment.

25. The Authority would be following general guidelines of the SREP as issued by the CEBS and prescribed in Appendix 3 to this Rule, albeit within the context of paragraph 12. Furthermore, the technical criteria on the SREP as prescribed in Annex 3B to this Rule would also be taken into account.

RISK ASSESSMENT SYSTEM

26. In order to carry out the initial phase of the SREP, the Authority intends to follow a risk assessment process similar to that outlined by CEBS in its GL03 document. Through this process, known as RAS, the supervisor will plan, prioritise and allocate supervisory resources according to requirements in order to attain stated objectives. These guidelines provide a structured and practical approach for the basis as to how the Authority intends to carry out this process.

ICAAP-SREP INTERACTION PROCESS

27. The Authority will explore through the dialogue with institutions, how institutions set their risk strategy, how they identify, measure, aggregate and monitor the risks they take, and how they set their overall risk-bearing capacity. The dialogue would be structured to cover elements such as internal governance (including risk controls, compliance, and internal audit), the organisation of the institution's business, and how the institution allocates capital against risk.

While the guidance on interaction and dialogue is directed mainly at the Authority, institutions will have a clear interest in knowing the approach that the Authority intends to take. Hence, following the reference to this in paragraphs 22-25 above, the ICAAP-SREP interaction process has also been illustrated in Annex 3A of this Rule.

27a. Within the interaction process, the Authority may, as part of its prudential measures, request credit institutions to allocate additional Pillar II capital for the difference in the level of an institution's non-performing exposures and impairments calculated on the basis of IFRS as adopted by the EU. Such allocations shall be in accordance with the methodology laid down in Banking Rule BR/09 to cover for any additional credit risk emanating from heightened levels of non-performing loans. The Authority thus considers that any determination on its part, for any additional Pillar II capital allocation to be required in line with paragraphs 37-40 of Banking Rule BR/09, falls within the prudential measures referred to in paragraphs 28 and 29 below.

PRUDENTIAL MEASURES

28. The conclusions drawn from the ICAAP-SREP interaction process may necessitate consideration by the Authority of the application of prudential measures, more so if the results of the institution's ICAAP are not considered satisfactory. Prudential measures which the Authority may consider are prescribed in Annex 3C to this Rule.

The Authority shall, as part of the necessary action that is available to it in pursuance of its role, require reinforcement of the arrangements, processes, mechanisms and strategies implemented by credit institutions to comply with the provisions of Articles 17B (Internal Governance) and 17C (ICAAP) of the Act.

29. The disclosure of prudential measures in Annex 3C should not be construed as implying that such measures would be limited to those indicated therein and is without prejudice to any other measure which the Authority is at law entitled to apply accordingly.

OBLIGATIONS OF THE AUTHORITY AS CONSOLIDATING SUPERVISOR

29a. In cases where a locally licensed credit institution has set up subsidiaries in any EEA country, the Authority in its role as consolidating supervisor shall ensure that agreement is reached with the relevant overseas competent authorities in relation to the adequacy of the consolidated own funds held by the said banking group and on the own funds of each individual entity within that group. Appendix 4 to this Rule details the process involved in reaching agreement – the so-called joint decision.

DEFINITIONS

30. For guidance purposes, a list of definitions which are generally used in the context of this Rule, are prescribed in Annex 2C.

PENALTIES

31. Any person who commits an offence in terms of this Rule as provided for under article 35 of the Act is liable to such penalties as may be prescribed pursuant to the said article.