PRINCIPLES FOR THE MANAGEMENT OF CONCENTRATION RISK

Credit institutions are to be guided by the Guidelines on the Management of Concentration Risk under the Supervisory Review Process (GL31) which were initially published by the Committee of European Banking Supervisors (CEBS) on 2 September 2010.

Following the mandate under Article 107(3) of the CRD, on the 19th of December 2014, the EBA issued Guidelines for Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (SREP). Such Guidelines, which are addressed, *inter alia*, to the authority, specify, in a manner that is appropriate to the size, the structure and the internal organisation of credit institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for the supervisory review and evaluation process referred to in Article 107(1) and in Article 97 of the CRD and for the assessment of the organisation and treatment of risks referred to in Articles 76 to 87 of the CRD, **in particular relating to concentration risk in accordance with Article 81 of the CRD.**

Furthermore, the following provisions shall apply:

CONCENTRATION RISK TO THE 'REAL ESTATE SECTOR'

Credit institutions which are considered by the authority as core domestic credit institutions (those which have strong links with the Maltese domestic economy, have a widespread local branch network and provide a full spectrum of banking services and are core providers of credit and deposit services in Malta) could, under normal circumstances, be substantially exposed to the real estate sector insofar as their credit portfolio is concerned, either directly to specific economic sectors (vide paragraph 2 below) or through exposure to physical collateral (usually in the form of real estate) covering most credit exposures. In fact, the most common form of asset class used as security, takes the form of hypothecs on property, be it domestic or commercial in nature.

For the purposes of this Rule, exposures to the Real Estate Sector shall be deemed to include those to the *Construction* sector (with *Construction and development of buildings* being the main sub-sector), *Real Estate activities* (with *Buying and selling of own real estate*, *Renting and operating of own or leased real estate* being the main sub-sectors) and *Households and individuals* (with *Acquisition of land/dwellings for own use* and *Construction, extension or completion of self-owned dwellings* being the main sub-sectors).

In view of the idiosyncratic risks arising from credit institutions' exposures to the Real Estate Sector, even indirectly through collateral securing an exposure/facility, credit institutions shall consider such risks as having additionally a Pillar II element.

In this context, credit institutions shall ensure that they regularly and adequately assess the risks to the Sector and take all the necessary measures to mitigate risks inherent in such exposures.

Other than on an individual exposure basis and the creation of impairments based on IFRS where these are required, credit institutions shall also take into account the fact that total exposures to the Real Estate Sector may constitute a concentration risk for a credit institution. For this reason, credit institutions shall ensure that:

(i) there is more rigorous and comprehensive analysis of proposals for lending to this Sector;

(ii) there is regular review of both the large exposures and other material exposures to this Sector;

(iii) collateral values are periodically monitored and valued regularly based on the principles laid down in Banking Rule BR/09, especially in case of *non-performing* facilities, in order to ensure the adequacy of consequent provisioning;

(iv) there is an adequate monitoring process over the conduct of facilities to this sector; and

(v) general measures are adopted to further mitigate residual risk if necessary, such as amendments to the credit institutions' relevant policies (e.g. amendments to set sector limits).

With regard to collateral monitoring and valuation mentioned in the third bullet point above, credit institutions shall pay particular attention to those exposures that rely on the value of collateral in assessing whether an impairment provision is required or otherwise. Accordingly, it is the credit institution management's responsibility to review the assumptions made within the context of the requirements of Banking Rule BR/09.

Accordingly, the authority expects credit institutions to implement an appropriate governance framework with the requisite assessment and internal control structures (as explained above, in line with the relevant requirements laid down in Banking Rule BR/09), which enables a credit institution's Board of Directors to assess the risk to its internal capital and monitor this on a regular basis. Mindful of the implications that this would entail, the authority expects that a credit institution's Board consequently provides policy direction to executive management which could take the form of increasing allocation of the credit institution's internal capital in respect of the said risk area, capping the risk by introducing thresholds as to the level of lending to the Real Estate Sector or where possible, reduce exposure through diversification and growth in other areas.