MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING RULES

BANKING RULE ON THE 'RISK-BASED METHOD' AND THE 'COMPENSATION CONTRIBUTION METHOD' UNDER THE DEPOSITOR COMPENSATION SCHEME REGULATIONS (S.L. 371.09)

Ref: BR/18/2016

INTRODUCTION

1. In terms of regulation 42 (1) and (2) of the Depositor Compensation Scheme Regulations, Subsidiary Legislation 371.09 ('the Regulations') under the Banking Act, the competent authority ('the authority'), as defined in regulation 2 of the Regulations, is empowered to issue Banking Rules to credit institutions. In compliance with Article 4 (10) of the Banking Act, 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. In accordance with regulation 25 (4) of the Regulations, the authority shall by Banking Rules establish a method ('the risk-based method') for determining the degree of risk incurred by members of the Depositor Compensation Scheme, and a method ('the Compensation Contribution method) for determining the amount of Compensation Contribution due by each member in each financial year. The risk-based method has been based on the 'EBA Guidelines on methods for calculating contributions to Deposit Guarantee Schemes', EBL/GL/2015/10.

DEFINITIONS

3. For the purpose of this Rule, the definitions contained in regulation 2 of the Regulations shall apply; and:

   "Adjustment Co-efficient" shall have the meaning assigned to it in regulation 25 (6) of the Regulations;

   "Risk-Adjusted Contribution" means the value of the cumulative Compensation Contribution by member '*i*' in a given financial year, excluding the adjustment co-efficient;

   "Year of Assessment" means the financial year when the Compensation Contribution is due.

INFORMATION REQUIREMENTS

4. In terms of regulation 25 (7) of the Regulations, every member shall on a quarterly basis and in the manner required by the authority, provide to the authority, the information specified in column 4 (Sheet Reference & Cell Reference) of Table 1 in Annex 1 of this Rule.

5. A member shall be deemed to have complied with the requirement of paragraph 4 of this Rule when it has disclosed to the authority the information specified in column 4 of Annex 1 in the manner required, for the purposes of: the Common Reporting (COREP) framework and the Financial Reporting (FINREP) framework established under Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, and the Implementing Technical Standards Amending

Commission Implementing Regulation (EU) No. 680/2014 on Supervisory Reporting of institutions.

6. The authority shall determine the Aggregate Risk Weight of each member (ARW) on the basis of the information disclosed by each member pursuant to paragraphs 4 and 5 of this Rule.

RISK INDICATORS USED TO DETERMINE THE ARW OF EACH MEMBER AND THE CALCULATION OF THE RISK INDICATOR VALUES

7. The authority shall determine the ARW of each member by (i) reference to the risk indicators in column 1 (Risk Categories & Core Risk Indicators) of Table 1 in Annex 1 of this Rule (ii) the methodology specified in the section of this Rule entitled 'Calculating the Aggregate Risk Weight (ARW)', and (iii) Annex 2 of this Rule.

8. For the purposes of calculating the ARW of each member, the authority shall use the values disclosed by each member as follows:

   the values as at 31 December of the financial year immediately preceding the year of assessment for information which is reportable by reference of the COREP / FINREP templates;

   the Return on Assets risk indicator (item 4.2 of Annex 1) reportable by reference to the FINREP templates shall be determined on the values of the two financial years immediately preceding the year of assessment in the manner specified in Annex 1 of this Rule.

9. The risk indicators shall be calculated on a solo basis, except as provided in paragraph 10 of this Rule.

10. The values used for the calculation of the risk indicators shall be calculated on a consolidated basis if the authority has granted a waiver in terms of Articles 7 and 8 of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

WEIGHTING OF RISK INDICATORS

11. The authority shall determine the risk weighting (*IWj*) applied to each risk indicator of a member (ARW) in accordance with Annex 1 of this Rule.

CALCULATING THE AGGREGATE RISK WEIGHT (ARW)

12. The authority shall determine the Individual Risk Score (*IRSj*) for each risk indicator *Aj*, in accordance with the methodology specified in Annex 2 of this Rule.

13. For the purposes of determining the Average Risk Score (ARS) for each member, the authority shall multiply the IRS determined for each risk indicator by the risk weight applicable to that risk indicator, according to the following formula:

$$ARS_i = \sum_{j=1}^{n} IW_j \times IRS_j$$

'IW_j' is the risk weighting of each risk indicator

'IRS_j' is the Individual Risk Score of each indicator

'n' is the total number of risk indicators which in this case is 7

$\sum_{j=1}^{n} IW_j = 100\%$

14. In determining the ARW_i of each member, the authority shall use the following formula:

$$ARW_i = 75\% + (150\% - 75\%)(1 - \log_{10}(10 - \left(9 \times \frac{ARS_i}{100}\right)))$$

'ARS_i' shall refer to the value calculated in accordance with paragraph 13 of this Rule.

METHOD FOR CALCULATING THE COMPENSATION CONTRIBUTION

15. The method for calculating the cumulative Compensation Contribution due by each member in every financial year shall be the following:

$$C_i = CR \times CD_i \times ARW_i \times \mu$$

C_i = The cumulative Compensation Contribution due by member '*i*' in a given financial year (hereinafter referred to as the "year of assessment").

CR = the Contribution Rate which is equivalent to the target level applicable to the year of assessment.

ARW_i = the Aggregate Risk Weight for member '*i*' as at 31 December of the year immediately preceding the year of assessment.

CD_i = the total covered deposits (excluding temporary high balances) for member '*i*' as at 31 December of the year immediately preceding the year of assessment.

μ = the adjustment coefficient applicable to all members for the year of assessment (refer to paragraph 16 of this Rule).

Provided that:

(a) Where covered deposits are held in a currency other than Euro (€), the amount of covered deposits shall be calculated on the Euro (€) equivalent of such covered deposits.

(b) The amount of covered deposits shall be based on information disclosed by a member for the purposes of article 22 (3) of the Regulations.

16. The authority shall determine the adjustment coefficient 'μ' in accordance with the following formula:

$$\mu = \frac{\text{Target level}}{\text{Total risk adjusted contribution}}$$

'Total risk adjusted contribution' is the summation of the value of each risk-adjusted contribution of each member.

ENTRY INTO FORCE

17. This Rule shall be deemed to have entered into force on 1 January 2016.

ANNEX 1
Risk Indicators

Table 1 shows the risk indicators used to determine the ARW of each member.

Table 1: Risk indicators and weighting

Risk Categories & Core Risk Indicators	Formula/Description	Title of Cell Reference	Sheet Number & Cell Reference	Risk Weight (IW)
Capital				**24%**
1.1 CET 1 Ratio	$\frac{\text{CET 1 Capital}}{\text{Risk Weighted Assets}}$ 'risk-weighted assets' means the total risk exposure amount as defined in Article 92(3) of Reg (EU) No 575/2013	$\frac{\text{'CET 1 Capital'}}{\text{'Total Risk Exposure Amount'}}$	$\frac{\text{COREP CA 1 R020 C010}}{\text{COREP CA 2 R010 C010}}$	12%
1.2 Leverage ratio[1]	$\frac{\text{Tier 1 Capital}}{\text{Total Assets}}$	$\frac{\text{'Tier 1 Capital'}}{\text{'Total Assets'}}$	$\frac{\text{COREP CA 1.00 R015 C010}}{\text{FINREP 1.1 R380 C010}}$	12%
Liquidity and Funding				**24%**
2.1 LCR (Liquidity Coverage Ratio)	The limit is changed from 60% in the year of assessment of 2016, to 70% in year of assessment of 2017, 80% in 2018 and 100% in 2019.	'Liquidity Coverage Ratio (%)'	COREP LCRDA 76 C010 R30	24%
2.2 NSFR (Net Stable Funding Ratio)	(This indicator will be included once it becomes available)			0%
Asset Quality				**18%**
3.1 Non-Performing Loans (NPL) ratio	$\frac{\text{Non Performing loans}}{\text{Total Loans \& Debt Instruments}}$ Where: 'Non-performing loans' as defined in the national regulations for the purpose of supervising members	$\frac{\text{'Total Non} - \text{performing loans and advances'}}{\text{'Total Gross carrying loans and advadnces'}}$	$\frac{\text{FINREP 18 R070 C060}}{\text{FINREP 18 R070 C010}}$	18%
Business Model & Management				**17%**
4.1 Risk Weighted Assets (RWA) / Total Assets	$\frac{\text{Risk Weighted Assets}}{\text{Total Assets}}$	$\frac{\text{'Total Risk Exposure Amount'}}{\text{'Total Assets'}}$	$\frac{\text{COREP CA 2 R010 C010}}{\text{FINREP 1.1 R380 C010}}$	8.5%
4.2 RoA (Return on	$\frac{\text{Net Income}}{\text{Total Assets}}$	$\frac{\text{'Profit or (}-\text{)loss for the year'}}{\text{'Total Assets'}}$	$\frac{\textit{FINREP 2 R670 C010}}{\textit{FINREP 1.1 R380 C010}}$	8.5%

[1] This is replaced by the leverage ratio as defined in Regulation (EU) No 575/2013 once it becomes fully operational.

Assets)	"Net Income" is set as the ratio of the 4-quarter moving sum of the flow value of profit as of end of Q1, Q2, Q3 and Q4 and "total assets" is the average value of assets as of the end of Q1, Q2, Q3 and Q4. - When there are sufficient FINREP returns then this will be averaged over two years. However, for contributions for 2016 only one year will be used. -If there are members that did not submit values for all 4 quarters, such as newly licenced banks, then all the available submitted values will be used to calculate this indicator.			
Potential losses for the DGS				**17%**
5.1 Unencumbered assets / Covered deposits	$\frac{\text{Total Assets} - \text{Encumbered Assets}}{\text{Covered Deposits}}$	$\frac{\text{'Total carrying amount of unencumbered assets'}}{\text{'Covered deposits Dec 15'}}$	$\frac{\text{FINREP AE 32.01 R010 C060}}{\text{"Covered deposits Dec 15"}}$	17%
TOTAL				**100%**

ANNEX 2
Sliding Scale method to calculate the IRS

As per paragraph 12 of this Rule, an IRS_j is attributed to each risk indicator A_j for each member '*i*'. For the indicators having an upper (a_j) and lower (b_j) boundary the IRS is determined by using a 'sliding scale method'. The IRS is assigned to the indicators range from 0 to 100, where 0 indicates the lowest risk and 100 indicates the highest risk.

When a higher risk indicator value indicates higher risk and the value is above the upper boundary the IRS_j is assigned a value of 100, whereas if the value is below the lower boundary the IRS_j is assigned a value of 0. For values between the lower and upper boundary, the IRS_j value is set between 0 and 100 according to the formula below:

$$IRS_j = \frac{A_j - b_j}{a_j - b_j} \times 100\%$$

'A_j' is the value of the risk indicator for member '*i*'.

When a higher risk indicator value indicates lower risk and the value is above the upper boundary the IRS_j is assigned a value of 0, whereas if the value is below the lower boundary the IRS_j is assigned a value of 100. For values between the lower and upper boundary, the IRS_j value is set between 100 and 0 according to the formula below:

$$IRS_j = - \frac{A_j - a_j}{a_j - b_j} \times 100\%$$

'A_j' is the value of the risk indicator for member '*i*'.

The upper and lower boundaries of each risk indicator are listed in Table 2 below. Note that for the LCR the upper boundary (a_j) is changed from 80% in the year of assessment of 2016, to 90% in year of assessment of 2017, 100% in 2018 and 120% in 2019.

Table 2: Risk indicator boundaries

Risk Indicators	Upper Boundary (aj)	Lower Boundary (bj)
CET1 Ratio	14%	7%
Leverage Ratio	4%	3%
LCR	80%	60%
NPL ratio	10%	5%
RWA/ Total Assets	60%	35%
RoA	1.5%	0%
Unencumbered Assets / Covered Deposits	200%	100%