MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING SUPERVISION UNIT

BANKING RULES

CAPITAL REQUIREMENTS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

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INTRODUCTION

1. In terms of Article 4 (2) of the Banking Act 1994 ('the Act') the competent authority ('the authority') as appointed under Article 3(1) of the Act may make Banking Rules as may be required for carrying into effect any of the provisions of the Act. The authority may amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to banks and the authority shall make copies thereof available to the public.

2. The Capital Requirements of Credit Institutions Rule ("the Rule") is being made pursuant to Article 17 of the Act.

SCOPE AND APPLICATION

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

4. The scope of the Rule is to standardise the criteria for the compilation of the Capital Requirements ratio and to establish a Capital Requirements Return for notification to the authority. 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.

CAPITAL REQUIREMENTS

5. Credit Institutions shall provide own funds which are at all times more than or equal to the sum of the following capital requirements:
   (a) for credit risk and dilution risk in respect of all of their business activities with the exception of their trading book business, the capital requirement shall be 8% of their risk-weighted exposure amounts calculated in accordance with this Rule.
   (b) in respect of their trading book business, for position risk and counterparty risk and, in so far as it is authorised that the limits laid down in Banking Rule BR/02 are exceeded, for large exposures exceeding such limits, the capital requirements shall be determined in accordance with Annex VI of Banking Rule BR/08.
   (c) in respect of all of their business activities, for foreign-exchange risk, for settlement risk and for commodities risk, the capital requirements shall be determined in accordance with Banking Rule BR/08
   (d) in respect of all of their business activities, for operational risk, the capital requirement shall be determined in accordance with Appendix 4 of this Rule.

6. The minimum level of the Capital Requirements ratio as defined in Appendix I of this Rule shall be 8%.

7. The authority may, at its discretion, set a higher minimum level for any particular credit institution.

8. The levels set under paragraphs 6 and 7 above shall apply both on a solo and on a consolidated basis.

9. Credit institutions shall permanently maintain at least the minimum level set under paragraphs 6 and 7 above as applicable.

10. All credit institutions shall calculate Capital Requirements on an individual basis. In the case of a parent undertaking, including a financial holding company, Capital Requirements shall also be calculated on a consolidated basis for that parent undertaking. Parent credit institutions and any of their subsidiaries may also be required to calculate Capital Requirements on a solo consolidated basis.

11. This Rule is structured in the following manner:

- Appendix 1 of this Rule sets out the General Framework for the computation of the Capital Requirements ratio.

- Appendix 2 sets out the details for the calculation of the Credit Risk capital requirements, with Section I defining the requirements under the Standardised Approach, Section II defining the requirements for the utilisation of the Internal Ratings Based Approach and Section III detailing the Credit Risk Mitigation techniques.
  It should be emphasised that, in assessing applications to utilise the IRB approach, the authority would be guided by the following CEBS[1]' guidelines:
  - Guidelines on the implementation, validation and assessment of AMA and IRB Approaches
  - Guidelines for co-operation between consolidating supervisors and host supervisors.

- Appendix 3 defines the details for the eligibility and calculation of Credit Risk capital requirement in respect of Securitisation transactions.

- Appendix 4 sets out the details for the calculation of capital requirements in respect of Operational Risk.
  It should be emphasised that, in assessing applications to utilise the Advanced Measurement Approach (AMA), the authority shall be guided by the following CEBS[1] Guidelines:
  - Guidelines on the implementation, validation and assessment of AMA and IRB Approaches
  - Guidelines for co-operation between consolidating supervisors and host supervisors. (where necessary)

[1] predecessor of EBA

Furthermore, institutions using AMA for the purpose of calculating the capital requirement for operational risk shall be guided by the following CEBS[1]/EBA Guidelines:

- Guidelines on Operational Risk Mitigation Techniques
- Guidelines on AMA – Extensions and Changes.

Moreover, the authority would adopt the supervisory procedures for extensions and significant changes, major changes and minor changes as provided for in the said EBA Guidelines on AMA – Extensions and Changes.

- ➢ Appendix 5 sets out the Capital Requirements Return which credit institutions are required to complete as notification to the authority under paragraphs 13 and 14. The Capital Requirements Return is to be submitted on a solo and on a consolidated basis, as applicable.

12. Apart from the Appendices mentioned in paragraph 11, the following Annexes are also attached to this Rule:

- ➢ Annex I - Definitions
- ➢ Annex II – Classification of Off-Balance Sheet Items
- ➢ Annex III – Types of Derivatives
- ➢ Annex IV – The Treatment of counterparty credit risk of derivative instruments, repurchase transactions and securities
- ➢ Annex V – Transitional Provisions

NOTIFICATIONS TO THE AUTHORITY

13. Article 17 of the Act requires a credit institution to notify the Capital Requirements to the authority. In this respect the authority requires credit institutions to submit the Capital Requirements Return as prescribed in Appendix 5 of this Rule on a quarterly basis which must coincide with balance sheet date. The authority's reporting framework in Appendix 5 adopts the framework on common reporting (COREP) developed by CEBS[1] but due to the nature, scale and complexity of the activities of credit institutions, due consideration has been given to the principle of proportionality in the adoption of the relevant COREP templates herein.

14. Article 17 of the Act also imposes the obligation on a credit institution to notify the authority forthwith upon the ratio falling below the required level under paragraphs 6 or 7 of the Rule as applicable to that institution. The authority requires such notifications to be submitted in the form of the Capital Requirements Return accompanied by the institution's representations of the circumstances leading to this position.

BRANCHES OF OVERSEAS INSTITUTIONS

15. Consequent to paragraph 9 of the Own Funds of Credit Institutions Rule (BR/03)

whereby a branch in Malta of an overseas institution is not required to maintain separate Own Funds, the Capital Requirements stipulated in this Rule do not apply.

16. The authority may however enter into a bilateral agreement with the foreign supervisory authority which has authorised and supervises the foreign credit institution, whereby the foreign supervisory authority shall be required to inform forthwith the authority in case of non-compliance by that institution in any manner whatsoever with the Capital Requirements rules of the foreign authority.

OFFENCES AND PENALTIES

17. 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 Section.

GENERAL FRAMEWORK

1.0.0 The Capital Requirements Ratio

1.1.0 The Capital Requirements ratio expresses own funds as a proportion of risk weighted assets and off-balance sheet items, together with notional risk weighted assets in respect of Operational Risk and Market Risk. Banking Rule BR/08 lays down the relevant criteria for the calculation of the latter risk.

2.0.0 The numerator: Own Funds

2.1.0 Own funds as defined in the Own Funds Rule BR/03 shall form the **numerator** of the Capital Requirements Ratio.

3.0.0 The denominator: Risk Weighted Assets

3.1.0 Credit Risk: Assets

3.1.1 To calculate the credit risk weighted assets, credit institutions may either utilise the Standardised Approach or the IRB Approach in line with Appendix 2 and 3, respectively

3.2.0 Credit Risk: Off-balance sheet items

3.2.1 The off-balance sheet items listed in Annex II, are subject to a two-stage calculation as follows:.

[a] They shall first be grouped according to the risk groupings set out in Annex II. The nominal/principal amount of the **full risk** items shall then be multiplied by a credit risk conversion factor (CCF) of 100%; **medium risk** items shall be multiplied by a CCF of 50%; **medium/low risk** items shall be multiplied by a CCF of 20%, while **low risk** items shall be multiplied by a CCF of 0%. When the nominal/principal amount is multiplied by the relevant credit conversion factor, the credit equivalent amount is achieved.

[b] The second stage shall be to treat the credit equivalent amount in the same manner as the Assets in paragraph 3.1.1.

3.3.0 Credit Risk: Counterparty credit risk

3.3.1 In the case of the interest rate and foreign exchange related derivative contracts listed in Annex III, repurchase transactions, securities or commodities lending or borrowing transactions and long settlement transactions, the exposure value shall be determined by means of one of the methods set out in Annex IV.

3.34.0 <u>Operational Risk</u>

3.4.1 To calculate the capital requirement in respect of Operational Risk, credit institutions may utilise one of the following approaches as detailed in Appendix 4:

a) Basic Indicator Approach

b) Standardised Approach

c) Alternative Standardised Approach

d) Advanced Measurement Approach

3.4.2 The capital requirement in respect of Operational Risk shall be multiplied by 12.5 (i.e. the reciprocal of the 8% capital requirement) in order to calculate the notional risk weighted assets for operational risk that need to be included in the denominator of the Capital Requirements ratio.

3.5.0 <u>Market Risk</u>

3.5.1 Trading book capital requirements, plus foreign exchange and commodity risk required on both banking and trading books, must be calculated in line with Banking Rule BR/08.

3.5.2 The capital requirement in respect of Market Risk shall be multiplied by 12.5 (i.e. the reciprocal of the 8% capital requirement) in order to calculate the notional risk weighted assets for market risk that need to be included in the denominator of the Capital Requirements ratio.

3.6.0 <u>Aggregate denominator</u>

The total of the risk adjusted values calculated under paragraphs 3.1.1 to 3.4.1 shall be the **denominator** of the Capital Requirements ratio.

CALCULATION OF CAPITAL ADEQUACY

1. Calculate Banking Book Capital Requirements

Banking book trigger = y (minimum set ratio at 8%)

	Risk Weighted Assets	**Capital Required***
Credit Risk	G	y% of G

**Calculated in accordance with Appendix 2 and 3*

2. Calculate Operational Risk Capital Requirements

	Capital Required**	**Notional Risk Weighted Assets**
Operational Risk	H	12.5 x H

***Calculated in accordance with Appendix 4*

3. Calculate Trading book capital requirements

Trading book trigger = y (minimum set ratio at 8%)

	Notional Risk Weighted Assets	**Capital Required**
Total trading book risks***	I	y% of G

****Calculated in accordance with Banking Rule BR/08.*

4. Allocate Capital to Banking Book Risks and Operational Risk

Maximise use of Additional Own Funds subject to limitations listed in the Own Funds Rule BR/03

5. Allocate Capital to Trading Book Risks

Maximise use of Additional Own Funds and Supplementary Own Funds subject to the limitations listed in the Own Funds Rule BR/03.

6. Identify any unused but eligible capital

The credit institution may find that it has unused (but eligible) Original Own Funds or Additional Own Funds. That is, the credit institution may (and should) have own funds in excess of the minimum requirement.

7. Calculate Supervisory Capital Adequacy:

$$\frac{\text{Total Own Funds}}{\text{Capital requirements}} \geq 1$$

8. Calculate Capital Requirements Ratio

$$\frac{\text{Total Own Funds}}{\text{Risk Weighted Assets and Notional Risk Weighted Assets}} \geq 8\%$$

9. Summary Schedule

Appendix 5 sets out the Capital Requirements Return which credit institutions are required to complete as notification to the authority under paragraphs 13 and 14. The Capital Requirements Return is to be submitted on a solo and on a consolidated basis, as applicable.