MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING SUPERVISION UNIT

BANKING RULES

OWN FUNDS 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 ('the Rules') as may be required for carrying into effect any of the provisions of the Act. The authority may amend or revoke such Rules. The 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 Own Funds Rule ('the Rule') is being made pursuant to Article 16A(5) of the Act, which states that:

   "The competent authority shall issue a Banking Rule as it shall consider appropriate for the regulation of own funds."

3. The Rule provides for a definition for the computation of the Own Funds of a credit institution authorised under the Act. The responsibility for observing the obligations in relation to the maintenance of Own Funds under the Act rests entirely with the credit institution's board of directors and its management.

SCOPE AND APPLICATION

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

5. Article 7(1)(a) of the Act requires a credit institution to have initial capital[1] amounting to not less than five million Euro (€5,000,000). Such amounts may be designated in such other currency as acceptable to the authority. On the other hand, Article 16A(1) of the Act requires a credit institution to ensure that its Own Funds may not fall below the amount of initial capital established in its licence, in terms of Article 7(1)(a) or such higher amount as may be required by the authority from time to time. As required under paragraph 17 of the Application Procedures and Requirements for Authorisation of Licences for Banking Activities Rule (BR/01), Appendix 1 and 2 of this Rule also apply, as appropriate, to an applicant for a licence under the Act in fulfilling the requirements of initial capital in line with Article 7(1)(a).

6. The scope of the Rule is to standardise the requirements for the compilation of Own Funds. To achieve this scope, the Rule has been modelled on the requisites of the European Union's Capital Requirements Directive 2006/48/EC – Chapter 2 – 'Technical Instruments of Prudential Supervision', the Committee of European Banking Supervisors' (CEBS) publication dated 21 December 2004, entitled 'Guidelines on Prudential Filters for Regulatory Capital', CEBS 'Implementation

[1] According to Article 2(1) of the Act, "initial capital" means paid up capital and reserves as defined in a Banking Rule on own funds. Accordingly, for the purposes of this Rule, initial capital is the sum of items 1.1.5 and 1.1.12 excluding items 1.1.9 and 1.1.11 of Appendix 1 and 2 of this Rule.

Guidelines for Hybrid Capital Instruments' issued on 10 December 2009 and CEBS 'Implementation Guidelines regarding Instruments referred to in Article 57(a) of Directive 2006/48/EC recast' issued on 14 June 2010.

7. The Rule takes into account the requirements of the Act and the Companies Act (Cap. 386) which mandates compliance by all companies with International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) as adopted by the European Union through Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 and the Commission Regulation (EC) No 1126/2008 of 3 November 2008, and any subsequent amendments thereto.

8. The Own Funds of a credit institution as calculated under this Rule shall be applied to:

    a. the calculation of Large Exposures in accordance with the Large Exposures of Credit Institutions Rule (BR/02) as provided for under Article 16 of the Act;

    b. the computation of Capital Requirements in accordance with the Capital Requirements of Credit Institutions Rule (BR/04) as provided under Article 17 of the Act, and the Capital Adequacy of Credit Institutions Rule (BR/08) as provided under Article 17 of the Act; and

    c. prohibited transactions as provided under Article 15 of the Act.

8A. A credit institution shall seek the authority's approval in terms of Article 13C(1)(d) of the Act prior to issuing convertible instruments referred to in paragraph 12 of this Rule and item 1.1.13 of Appendix 2 to this Rule. Such instruments shall be eligible as Original Own Funds following the authority's approval.

BRANCHES OF THIRD COUNTRY CREDIT INSTITUTIONS

9. Paragraph 29 of BR/01 states that a licence issued to a credit institution incorporated in a third country to carry on its business of banking through a branch in Malta is deemed to having been granted to that institution as a whole and there is therefore no requirement for such a branch to have an Own Funds requirement under Article 7(1)(a) of the Act. Consequently this Rule does not apply to branches established locally of institutions from third countries.

COMPONENTS OF OWN FUNDS

10. Appendix 2 to this Rule sets out and defines the components constituting the Own Funds of a credit institution. These are divided in three categories: Original Own Funds (paid up capital, reserves and other instruments), Additional Own Funds (upper tranche and lower tranche) and Supplementary Own Funds.

11. The above three categories reflect differences in the extent to which the capital instruments concerned meet the purpose and conform to the following characteristics:

    (i) permanence: the instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress;

    (ii) loss absorption capacity: the instrument must be available to absorb losses, both on a going-concern basis[2] and in liquidation, and to provide support for depositors' funds if necessary; and

    (iii) flexibility of on-going payments (no fixed cost): the instrument must contain features permitting the non-cumulative deferral or cancellation of payment of coupons or dividends in times of stress.

    The extent to which these three criteria are fulfilled not only determines the classification of capital instruments into the different categories of regulatory Own Funds but also determines any limitations on their use.

12. For the purposes of this Rule, Original Own Funds are divided into paid up capital (item 1.1.5), reserves (item 1.1.12) and other instruments (item 1.1.13).

    Original Own Funds shall be available to a credit institution for unrestricted and immediate use to cover risks or losses as soon as these occur. The amount shall be net of any foreseeable tax charge at the moment of its calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses.

    The authority expects that paid up capital and reserves be the predominant form of a bank's Original Own Funds. They are a bank's highest quality capital, the most reliable and liquid element of a bank's capital.

    Paid up capital is made up of ordinary shares, share premium accounts and perpetual non-cumulative preference shares. These shall fully absorb losses in going concern situations, and in the event of bankruptcy or liquidation shall rank after all other claims.

    Other instruments are made up of convertible instruments, innovative instruments and non-innovative instruments. These are capital instruments that have both equity and debt-like features.

    Convertible instruments are instruments that must be converted during emergency situations and may be converted at the initiative of the authority, at any time, based on the financial and solvency situation of the issuer into ordinary shares within a pre-determined range. The intention is to ensure that these instruments shall have the same permanence as ordinary shares. The presence of a call option for these instruments may reduce their permanence. Consequently, only instruments that cannot be redeemed in cash but can only be converted into

[2] Instruments that are able to absorb losses on a going-concern basis help a credit institution to incur a loss but remain solvent and viable, even if distributable reserves have already been depleted.

ordinary shares shall be considered convertible instruments. The latter does not prejudice the instrument's eligibility as innovative or non-innovative instruments.

In case of an emergency situation, conversion into ordinary shares shall be mandatory in order to help the institution remain solvent. The authority does not intend to define precisely all the cases that should be considered as an "emergency situation" triggering the mandatory conversion. At least, a breach of regulatory limits, such as the capital requirements ratio, should be considered to be an emergency situation. However, where the authority has set higher limits or conditions, reference could be made to such higher limits or conditions. The emergency situations are to be clearly defined within the terms of the convertible instrument, legally certain and transparent.

Even though a credit institution still meets the minimum Capital Requirements in accordance with BR/04, the authority may deem the amount or the composition of the credit institution's own funds as inadequate to cover the risks assessed in the credit institution's Supervisory Review and Evaluation Process and require the conversion.

With respect to the authority's option to trigger the conversion of the convertible instrument, it is important that no contractual clause prevents the authority from exercising this option, while the issuer may have an option to convert at any time.

Regardless of the reason for the conversion, convertible instruments shall be converted into ordinary shares within a predetermined range. The objective of the predetermination of ordinary shares into which convertible instruments will be converted is to ensure that they will share losses from the trigger point on, that is the downside risk, pari passu with shareholders since the issue.

In order to achieve this objective, the amount of ordinary shares to be delivered should be determined on the basis of the market value of ordinary shares at its date of issue (in order to equal the nominal value). The mechanism of conversion may reduce the number of shares to be issued if the share price increases but not increase such number if the share price decreases.

The obligation to have a predetermined conversion ratio does not prevent some technical adjustments to the pre-fixed conversion ratio in case of extraordinary operations on company capital (i.e. mergers, acquisitions, break-up, reorganisation, grouping of shares, etc.).

Innovative instruments are: (i) dated instruments with an original maturity of at least 30 years whose redemption may be suspended; and (ii) instruments with provisions that provide for an incentive for the credit institution to redeem. An incentive to redeem [3] in this sense is, in principle, any feature that provides for an expectation of the instrument being redeemed at the call date, notably an interest

[3] Incentives to redeem may place (economic, reputational or similar) pressures on an issuer to call and refinance an other instrument even though an issuer is experiencing some deterioration in its financial position. The issuer might feel obliged to initiate the call even though the refinancing may lead to a weaker capital structure or reduce future financial flexibility. Instruments with moderate incentives to redeem are therefore limited to 15% of original own funds.

rate step-up[4] or a principal stock settlement[5] clause, in conjunction with a call option. The existence of an incentive to redeem will be determined at the issue date.

Non-innovative instruments are undated instruments and do not provide for an incentive for the credit institution to redeem. Instruments with an incentive to redeem which are not called shall not be re-classified as non-innovative instruments.

Other instruments should meet all three criteria of permanence, loss absorption capacity and flexibility of on-going payments as per paragraph 11 above. It is to be noted that innovative instruments could incorporate certain features, such as the incentive to redeem, the effect of which is to weaken (but only marginally) the extent to which all three criteria are fulfilled since incentives to redeem potentially compromise the permanence of other instruments.

Other instruments issued through a Special Purpose Vehicle (SPV), which is a subsidiary of a credit institution, can be included within the consolidated own funds but shall be included within the limit set for innovative instruments. Where an SPV undertakes other business apart from the issuance of other instruments, other instruments are to be ring-fenced so that they do not have an enhanced claim in insolvency. Other instruments that are indirectly issued shall comply with the conditions for qualification as original own funds as if the SPV was itself a credit institution seeking to include that capital in its original own funds.

Investors in other instruments shall retain at least the same degree of subordination in insolvency and on an on-going basis as if the instrument was issued directly by the parent. They must, however, not be in a position to place the SPV into insolvency nor should they, in the case of the collapse of the SPV

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[4] Step-ups are permitted, in conjunction with a call option, only if they are considered moderate, i.e. if they result in an increase over the initial rate that is no greater than, either:

- 100 basis points less the swap spread between the initial index basis and the stepped-up index basis; or
- 50% of the initial credit spread less the swap spread between the initial index basis and the stepped-up index basis.

The terms of the instrument shall provide for no more than one rate step-up over the life of the instrument. The swap spread shall be fixed at the pricing date and reflect the difference in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

[5] A principal stock settlement mechanism in conjunction with a call option shall contain a cap on the conversion ratio in order to be considered a moderate incentive to redeem. The cap on the conversion ratio at the date of redemption shall not be more than 150% of the conversion ratio at the time of issue. A principal stock settlement feature should not be confused with mandatory convertible securities (MCS). MCS do not provide the issuer with an incentive to redeem because there is no call option and the instrument would be issued to equity or equity-linked investors who will receive ordinary shares on conversion after a specified period (e.g. three years). The maximum number of ordinary shares (M) that a single par value other instrument can be converted into is calculated as follows:

M = Par value of other instrument x 150% / market value of the share into which they are to be converted on the day of issue of the other instrument.

structure, have a better claim against the institution than holders of the same type of instrument directly issued by the institution.

13. Additional Own Funds consist of lower quality items than items eligible as Original Own Funds since they do not fully meet the requirements for permanence and/or absence of fixed servicing costs that apply to Original Own Funds.

    Additional Own Funds are split into 'Upper' and 'Lower' tranches depending on the extent to which the Additional Own Funds items concerned have the ability to absorb losses and provide a degree of funding flexibility to the institution.

    Only perpetual capital instruments may be included in the upper tranche of Additional Own Funds. Examples of such instruments are:

    (i) perpetual cumulative preference shares;
    (ii) perpetual subordinated debt; and
    (iii) other instruments that have the same economic characteristics as (i) or (ii) above.

    Additional Own Funds items which are not perpetual or which may have fixed servicing costs that cannot generally be either waived or deferred (for example, most subordinated debt) may be included in the lower tranche of Additional Own Funds. Such items should normally be of a medium to long-term maturity (that is, an original maturity of at least five years). Dated instruments are to be included in the lower tranche of Additional Own Funds.

14. Supplementary Own Funds consist of items conforming least well to the characteristics of capital listed in paragraph 11 of this Rule: either subordinated debt of short maturity or net trading book profits.

CONSOLIDATED OWN FUNDS

15. Further to the provisions of paragraph 10.0.0 of Appendix 2 of this Rule, in reporting Own Funds on a consolidated basis pursuant to the Supervision on a Consolidated Basis Rule (BR/10), credit institutions are required to determine the composition of the banking group to be consolidated in terms of paragraph 6 of the latter Rule. However, it is to be noted that according to paragraph 7 of BR/10, the authority reserves the right to determine other undertakings not defined in paragraph 6 that could qualify for inclusion for supervision on a consolidated basis.

COMPLIANCE

16. Original Own Funds and Additional Own Funds may be used to support both banking and trading book activities under BR/04 and BR/08 respectively.

17. Supplementary Own Funds may only be used to support trading book activities as defined in BR/08.

18. Compliance with the conditions of this Rule must be proved to the satisfaction of the authority.

19. The computation of Own Funds is subject to the limitations specified in paragraph 9.0.0 of Appendix 2 of this Rule.

OFFENCES AND PENALTIES

20. 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.