

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING SUPERVISION 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 defined in Article 2(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 credit 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 of the Act requires credit institutions to establish their own ICAAP. Furthermore, the authority shall carry out a supervisory review and evaluation process (SREP) over licensed credit institutions. Notwithstanding that, as explained below, since 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

4. 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. The Rule is modelled on the requisites of Directive 2013/36/EU of 26 June 2013 (the [CRD](#)). In this context, it should be emphasised that in drafting this document, the authority has been guided by the [Guidelines on the Application of the Supervisory Review Process under Pillar 2 \(GL03\)](#) which were published by the Committee of European Banking Supervisors (CEBS) on 25 January 2006. The European Banking Authority (EBA) is currently developing '[Guidelines on Supervisory Review and Evaluation Process \(SREP\) and Pillar 2](#)' following the mandate under Article 107(3) of the [CRD](#). Such Guidelines, which implement provisions of the [CRD](#), shall be addressed to *inter alia* the authority, shall specify, in a proportionate manner, the common procedures and methodologies for the supervisory review and evaluation process and the

assessment of the organisation and the risks faced by credit institutions. The authority shall be guided by the latter Guidelines.

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

LEVEL OF APPLICATION

Internal capital adequacy assessment process (ICAAP)

6. Every credit institution licenced in terms of the Act which is neither a subsidiary in Malta, nor a parent undertaking, and every credit institution not included in the consolidation pursuant to Article 19 of Regulation (EU) No 575/2013 (the CRR) shall meet the obligations set out in Article 17C of the Act on an individual basis.
 - 6a. Credit institutions licensed in terms of the Act which are parent institutions, shall, to the extent and in the manner prescribed in Part One, Title II, Chapter 2, Sections 2 and 3 of the CRR (Articles 18 to 24), meet the obligations set out in Article 17C of the Act on a consolidated basis.
 - 6b. Credit institutions licensed in terms of the Act controlled by a parent financial holding company or a parent mixed financial holding company in a Member State shall, to the extent and in the manner prescribed in Part One, Title II, Chapter 2, Sections 2 and 3 of the CRR (Articles 18 to 24), meet the obligations set out in Article 17C of the Act on the basis of the consolidated situation of that financial holding company or mixed financial holding company.
 - 6c. Where more than one institution is controlled by a parent financial holding company or a parent mixed financial holding company in a Member State, paragraph 6b shall apply only to the credit institution to which supervision on a consolidated basis applies in accordance with Article 111 of the [CRD](#).
 - 6d. Subsidiary credit institutions shall apply the requirements set out in Article 17C of the Act on a sub-consolidated basis if those credit institutions, or the parent undertaking where it is a financial holding company or mixed financial holding company, have an institution or a financial institution or an asset management company as defined in regulation 2(1) of the [Financial Conglomerates Regulations](#) as a subsidiary in a third country, or hold a participation in such an undertaking.

Credit institutions' arrangements, processes and mechanisms

- 6e. Credit institutions shall meet the obligations set out in Section II of Chapter 2 of Title VII (Articles 74 to 96) of the [CRD](#) on an individual basis, unless the authority makes use of the derogation provided for in Article 7 of the CRR.

- 6f. Parent undertakings and subsidiaries subject to the [CRD](#) shall meet the obligations set out in Section II of Chapter 2 of Title VII (Articles 74 to 96) of the [CRD](#) on a consolidated or sub-consolidated basis, to ensure that their arrangements, processes and mechanisms pursuant to such objectives are consistent and well-integrated and that any data and information relevant to the purpose of supervision can be produced. In particular, they shall ensure that parent undertakings and subsidiaries subject to the [CRD](#) implement such arrangements, processes and mechanisms in their subsidiaries not subject to the [CRD](#). Those arrangements, processes and mechanisms shall also be consistent and well-integrated and those subsidiaries shall also be able to produce any data and information relevant to the purpose of supervision.
- 6g. Obligations resulting from Section II of Chapter 2 of Title VII (Articles 74 to 96) of the [CRD](#) concerning subsidiary undertakings, not themselves subject to the [CRD](#), shall not apply if the EU parent institution or credit institutions controlled by an EU parent financial holding company or EU parent mixed financial holding company, can demonstrate to the authority that the application of Section II of Chapter 2 of Title VII (Articles 74 to 96) of the [CRD](#) is unlawful under the laws of the third country where the subsidiary is established.
- 6h. The authority shall apply the Supervisory Review and Evaluation Process referred to in Section III of Chapter 2 of Title VII (Articles 97 to 101) of the [CRD](#) and the supervisory measures referred to in Section IV of Chapter 2 of Title VII (Articles 102 to 107) of the [CRD](#) in accordance with the level of application of the requirements of the CRR set out in Part One, Title II (Articles 6 to 24) of that Regulation.

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.
8. Credit institutions shall take the necessary measures at an early stage to prevent capital from falling below the minimum levels required to support its risk characteristics.

Obligations of the authority

9. 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.
10. The authority shall have the supervisory powers indicated in paragraphs 28 and 29.

DISCLOSURE AND TRANSPARENCY

11. The key element of the SREP is the dialogue between the authority and credit institutions. Whilst the ICAAP remains the credit 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 the technical criteria laid down in Article 98 of the [CRD](#).

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 credit institutions' ICAAP, as prescribed in paragraphs 16-21, as well as the authority's SREP mentioned in paragraphs 22-26. 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 credit institution's business activities. Smaller credit 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^{1, 2}

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.

¹ On 27 September 2011 the European Banking Authority (EBA) published its [Guidelines on Internal Governance \(GL44\)](#) aiming at enhancing and consolidating supervisory expectations and to ultimately improve the sound implementation of internal governance arrangements.

² On 22 November 2012, the European Banking Authority (EBA) published its [Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders \(EBA/GL/2012/06\)](#). These Guidelines set out the process, criteria and minimum requirements for assessing the suitability of those persons and are ultimately aimed at ensuring robust governance arrangements and appropriate oversight.

14. Internal governance aims at ensuring that a credit institution's management body (the Board of Directors) 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 credit institution's business objectives and its appetite for risk, how the business of the credit 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 (as referred to 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, the Principles for Remuneration Policies and Practices (as referred to in Annex 2E to this Rule) and the [Guidelines on the Management of Operational Risk in Market-Related Activities](#) (as referred to in Annex 2I to this Rule) are also to be taken into account. Credit institutions should also note the "[Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk](#)" issued by the CEBS on 8 September 2009 and updated on 27 July 2010.
- 15a. Credit institutions shall submit to the authority information on the number of individuals that are remunerated €1 million or more per financial year, including their job responsibilities, the business area involved and the main elements of salary, bonus, long-term award and pension contribution.
- 15b. Credit institutions shall have in place adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures in order to identify, measure, monitor and control transactions with their parent mixed-activity holding company and its subsidiaries appropriately. Credit institutions shall report any significant transaction with those entities other than the one referred to in Article 394 of the CRR (Large Exposures - Reporting Requirements). Those procedures and significant transactions shall be subject to overview by the authority.

INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

16. Within the credit institution's internal governance framework, the ICAAP is a process that the Board of Directors utilises to ensure that:
 - there is adequate identification, measurement, aggregation and monitoring of the credit institution's risks,
 - adequate internal capital is held by the credit institution in relation to its risk profile, and

- the credit 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 credit 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 'Principles for the Management of Interest Rate Risk in the Banking Book (IRRBB)' (as referred to in Annex 2F to this Rule) and the 'Principles for the Management of Concentration Risk' (as referred to in Annex 2G to this Rule) under the Supervisory Review Process , 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 credit 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 the 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 a credit institution's 'tool-kit' used for the assessment of risks within the ICAAP is the use of stress testing. While a credit 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 credit 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 credit institutions (as laid out in Annex 2D to this Rule). 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 that the Principles do not only relate to stress testing requirements as part of a credit institution's ICAAP process, but also to stress testing as a key risk management tool within credit 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 credit 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 its supervisory powers 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 the measures required by the authority's exercise of its supervisory powers 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 referred to in Appendix 3 to this Rule), albeit within the context of paragraph 12. Furthermore, the technical criteria on the SREP (as referred to in Annex 3B to this Rule) would also be taken into account.

RISK ASSESSMENT SYSTEM (RAS)

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 in the [Guidelines on the Application of the Supervisory Review Process under Pillar 2 \(GL03\)](#) and any reviews and/or updates that may be undertaken to such Guidelines from time to time. 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 credit institutions, how credit 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 credit institution's business, and how the credit institution allocates capital against risk.

While the guidance on interaction and dialogue is directed mainly at competent authorities, credit institutions will have a clear interest in knowing the approach that the authority intends to take in this area. Hence, following the reference to this in paragraphs 22-26 above, the ICAAP-SREP interaction process has also been referred to in Annex 3A of this Rule.

- 27a. Within the interaction process, the authority may, through the exercise of its supervisory powers, request credit institutions to allocate additional Pillar II capital in line with Article 104(1)(a) of the [CRD](#) for the difference in the level of a credit 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 its supervisory powers referred to in paragraphs 28 and 29 below.

SUPERVISORY POWERS

28. The conclusions drawn from the ICAAP-SREP interaction process may necessitate consideration by the authority of the application of its supervisory powers, more so if the results of the credit institution's ICAAP are not considered satisfactory.

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 authority's supervisory powers shall at least include those listed in Article 104 of the [CRD](#) and is without prejudice to any other powers which the authority is at law entitled to apply accordingly.

DEFINITIONS

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