

INVESTMENT SERVICES RULES FOR INVESTMENT SERVICES PROVIDERS

PART B: STANDARD LICENCE CONDITIONS

Appendix 10

Requirements on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders

Introduction

Risk

Risk can be defined as the combination of the probability of an event and its consequences. In all types of undertaking, there is the potential for events and consequences that constitute opportunities for benefit (upside) or threats to success (downside).

Risk Management

Risk management is about sound management of an organisation and the establishment of systems to avoid adverse effects and to take advantage of opportunities.

Risk management is a central part of any organisation's strategic management. It is the process whereby organisations methodically address the risks attaching to their activities with the goal of achieving sustained benefit within each activity and across the portfolio of all activities.

The focus of good risk management is the identification and treatment of these risks. Its objective is to add sustainable value to all the activities of the organisation. It marshals the understanding of the potential upside and downside of all those factors which can affect the organisation. It increases the probability of success and reduces both the probability of failure and the uncertainty of achieving the organisation's overall objectives.

Risk management should be a continuous and developing process which runs throughout the organisation's strategy and implementation of the strategy. It must be integrated into the culture of the organisation with an effective policy and a programme led by the most senior management. It must translate the strategy into tactical and operational objectives, assigning responsibility throughout the organisation with each manager and employee responsible for the management of risk as part of their job description. It supports accountability, performance measurement and reward, thus promoting operational efficiency at all levels.

Purpose & Contents

Certain Investment Services Licence Holders [henceforth referred to as ‘Licence Holders’] are, in terms of the Rules which apply to these types of institutions, required to identify the risks relating to their activities, processes and systems, and to manage these risks effectively.

This Appendix implements part of the Pillar II requirements of the CRD. It is divided into two parts: **Part A** explains the Risk Management and Internal Capital Adequacy Assessment Process and outlines the manner in which a Licence Holder shall compile an RMICAAP Report. **Part B** explains the technical criteria on the review and evaluation by the MFSA of a Licence Holder’s RMICAAP.

Part A

The Risk Management and Internal Capital Adequacy Assessment Process

Risk management covers all processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them and monitoring and reviewing progress.

The internal capital adequacy assessment process has the purpose of: **[a]** ensuring that the Licence Holder adequately identifies, measures, aggregates and monitors its risks; **[b]** holds adequate internal capital in relation to its risk profile; and **[c]** uses sound risk management systems.

The risk management and internal capital adequacy assessment process (RMICAAP) can be subdivided into six stages: **[i]** risk identification; **[ii]** description of risk; **[iii]** risk estimation; **[iv]** risk tolerance and evaluation; **[v]** risk treatment; and **[vi]** risk recording/ reporting.

[I] Risk Identification

Risk identification is the process whereby the Licence Holder identifies its exposure to uncertainty. This requires an intimate knowledge of the organisation, the market in which it operates, the legal, social, political and cultural environment in which it exists, as well as the development of a sound understanding of its strategic and operational objectives, including factors critical to its success and the threats and opportunities related to the achievement of these objectives.

The purpose of this initial stage in the risk management process is to record (in a structured form) as many risks as possible which might hinder the Licence Holder in attaining its goals. Risk identification should be approached in a methodical way to ensure that all significant activities within the organisation have been identified and all the risks flowing from these activities defined.

This is especially important given that it sets the stage for the remainder of the risk management process.

The following is a list of risks to which a Licence Holder may be exposed:

[a] Pillar I Financial Return - Non-Trading Book Business Risks

[a 1] Credit/Counterparty risk: This being the probability of a loss occurring due to: [i] the failure of a debtor of a Licence Holder to meet its contractual debt obligations; or [ii] the loss in value of any other asset (excluding derivatives which are exclusively dealt with in the sections on trading book business and commodities instruments – risk component) which forms part of the Licence Holder's balance sheet except for: (a) intangible assets including goodwill; (b) cash in hand and at bank; (c) those financial instruments which fall within the category of trading book business; and (d) commodity positions.

[a 2] Free deliveries: Free Deliveries caters for the risk that the Licence Holder has either: (a) paid for free deliveries transactions in financial instruments which qualify as trading book business before receiving them; or (b) has delivered financial instruments which qualify as trading book business, sold in a free deliveries transaction, before receiving payment for them.

In relation to Credit/Counterparty risk and free deliveries, the Licence Holder shall assess whether these risks are fully captured by the Pillar I requirements as reflected in the automated COREP Return which the Licence Holder is required to submit in terms of the applicable MFSA rules i.e. For Investment Services Licence Holders - Part BI of the Investment Services Rules for Investment Services Providers.

[b] Pillar I Financial Return - Trading Book Business Risks

[b 1] Position Risk: The risk of losses, arising from movements in market prices, in on and off balance sheet investments in financial instruments which qualify as trading book business.

[b 2] The counterparty credit risk component: 'Counterparty Credit Risk' or 'CCR' means the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

In relation to Trading Book Business risks, the Licence Holder shall assess whether the above-mentioned risks are fully captured by the Pillar I requirements as reflected in the automated COREP Return which the Licence Holder is required to submit in terms of the applicable MFSA rules.

[c] Other Risks covered in the Licence Holder's Pillar I Financial Return

[c 1] Commodities Risk: The risk of holding or taking positions in commodities such as physical products which are and can be traded in the secondary market including commodity derivatives.

[c 2] Large Exposures: Is defined as an exposure to a client or group of connected clients where its value is equal to or exceeds 10% of the Licence Holder's eligible capital – [applicable to Category 3 investment services licence holders].

The Large Exposures risk is related to Concentration Risk. **Concentration Risk** is defined in the [CEBS Guidelines](#) as:

Exposure(s) that may arise within or across different risk categories throughout an institution with the potential to produce: (i) losses large enough to threaten the institution's health or ability to maintain its core operations; or (ii) a material change in an institution's risk profile.

[c 3] Foreign Exchange Risk: The risk that an asset or liability denominated in a currency other than the reporting currency may be adversely affected by a change in the value of the foreign currency.

[c 4] Operational Risk: Is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk – [applicable to Category 3 investment services licence holders].

[c 5] Settlement Risk: Settlement risk is the risk that the Licence Holder's cash against documents transactions in financial instruments are unsettled after their due delivery dates.

[c 6] Credit Valuation Adjustment (CVA) Risk: The term 'CVA' is defined in article 381 of the CRR as an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty. That adjustment reflects the current market value of the credit risk of the counterparty to the Licence Holder, but does not reflect the current market value of the credit risk of the Licence Holder to the counterparty.

In relation to the other risks covered in the Licence Holder's Pillar I Financial Return, the Licence Holder shall assess whether the above-mentioned risks are fully captured by the Pillar I requirements as reflected in the automated COREP Return which the Licence Holder is required to submit in terms of the applicable MFSA rules.

[d] Other Possible Risks

[d 1] Liquidity Risk¹: The risk that the Licence Holder cannot meet its financial obligations, such as payments and collateral needs, as they fall due in the short term and medium term, either at all or without incurring unacceptable losses.

[d 2] Compliance Risk: The risk of legal or regulatory sanctions, financial loss, or reputational impact due to a failure to comply with laws, regulations, standard or codes of conduct.

[d 3] Technology Risk: The risk of loss associated with failed, compromised or inadequate information technology on which the business depends and which can further expose an organisation to additional risk – legal, regulatory, reputation, revenue, and so forth.

[d 4] Strategic Risk: The risk of loss arising from adverse business decisions that poorly aligns to strategic goals, failed execution of policies and processes designed to meet those goals, and inability to respond to macro-economic and industry dynamics.

[d 5] Securitisation Risk: The risk arising from securitisation transactions in relation to which the Licence Holder is an investor, originator or sponsor, including reputational risks (such as arise in relation to complex structures or products).

Securitisation in this context means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having both of the following characteristics:

- a) Payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and
- b) The subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

where for the purposes of this point, the term:

‘originator’ means either of the following: (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) an entity which purchases a third party’s exposures for its own account and then securitises them;

¹ Reference is made to EBA’s [Discussion paper on the draft methodology for assessment of liquidity and funding risk under SREP](#) for the definition of liquidity risk.

‘sponsor’ means a Licence Holder other than an originator Licence Holder that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities;

‘asset-backed commercial paper (ABCP) programme’ means a programme of securitisations the securities issued by which predominantly take the form of commercial paper with an original maturity of one year or less’;

‘tranche’ means a contractually established segment of the credit risk associated with an exposure or a number of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.

[d 6] Remuneration Risk: The risk that the remuneration structures and the remuneration policies of the Licence Holder provide incentives to take risks that exceed the general level of risk tolerated by the Licence Holder, exacerbating excessive risk-taking behaviour.

[d 7] Risk of Excessive Leverage: The risk resulting from the Licence Holder’s vulnerability due to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets.

[d 8] Interest Risk arising from Non-Trading Book Activities

For the purpose of these rules, ‘interest rate risk arising from non-trading activities’ is referred to as ‘interest rate risk in the banking book’.

In terms of the [EBA Guidelines](#), interest rate risk in the banking book is defined as the current or prospective risk to both the earnings and capital of institutions, in respect of the banking book only, arising from adverse movements in interest rates.

[d 9] Residual Risk: The risk that recognised credit risk mitigation techniques used prove less effective than expected.

[II] Description of Risk

The objective of risk description is to display the risks in a structured format. The use of a well-designed structure is necessary to ensure a comprehensive risk identification and description process. This will in turn assist the Licence Holder in assessing the risk.

At this stage, the Licence Holder shall prepare a table which indicates the risk to

which the Licence Holder is exposed and the nature of such risk.

[III] Risk Estimation

Risk estimation is a combination of **IMPACT** [being the potential harm that could be caused] and **PROBABILITY** [the likelihood of the particular event occurring]. It is recommended that Licence Holders assess their risks in terms of possible impact and probability.

Depending on the type of risk, the **impact assessment** may take the form of a quantitative and/or qualitative assessment. A **quantitative assessment** is carried out by calculating the possible financial impact on the Licence Holder of the occurrence of a specific risk. A **qualitative assessment** is the assessment of a risk in terms of a possible impact: **[a] which cannot be quantified** e.g. impact of possible reputational risk due to the inadequate provision of an investment service; **or [b] the quantification of which cannot be calculated in its entirety** e.g. impact of the imposition by the MFSA of an administrative penalty and the publication of such penalty on the MFSA's web-page.

Probability is defined as the likelihood of the occurrence of a risk. This is usually based on the history of occurrences of the same risk or similar risks. The Licence Holder shall classify the probability of a risk as either: **High** – There is more than 75% chance of occurrence; **or Medium** - There is from 25% to 75% chance of occurrence; **or Low** - There is less than 25% chance of occurrence.

Where the impact of a risk is quantifiable in its entirety, the Licence Holder shall quantify its **Gross Risk**, this being the multiplication of the impact assessment by the percentage probability of occurrence.

[IV] Risk Tolerance and Evaluation

Risk tolerance is equivalent to the amount of risk which the Licence Holder is willing to take in order to achieve its strategic and business objectives. The higher the Licence Holder's risk tolerance, the more risk such Licence Holder is willing to take.

Risk evaluation is the process used to determine risk management priorities by comparing the level of risk against the Licence Holder's level of tolerance, this with the purpose of determining which risks are acceptable.

Further to quantifying its risks, the Licence Holder shall establish its level of risk tolerance and evaluate its risks by comparing the estimated risks against the risk tolerance criteria which it has established. Through this risk evaluation process, the Licence Holder shall make decisions regarding the significance of risks and whether each specific risk ought to be accepted or treated.

[V] Risk Treatment

Risk treatment is the process of selecting and implementing measures to mitigate the risk to which the Licence Holder is exposed with the aim of bringing such risk within the parameters of the Licence Holder's risk tolerance levels. Risk treatment can take the form of either: **[i]** risk control; or **[ii]** risk transfer; or **[iii]** risk financing. The Licence Holder may choose to take a combination of measures in order to mitigate its risks.

[A] Risk Control are measures which aim at either reducing the likelihood or consequences or both of a risk occurring – e.g. stress testing the business of the Licence Holder by contemplating a scenario where the business of the Licence Holder is reduced by 30% and in turn: **[i]** analysing the impact of such a reduction in business on the Licence Holder's capital resources – i.e. in such a scenario will the Licence Holder continue satisfying the capital resources requirement; and **[ii]** considering the action which the Licence Holder's person could take in order to mitigate a possible deficit of the capital resources requirement – e.g. possibly entering into a subordinated loan agreement.

[B] Transfer of Risk this is a process whereby the Licence Holder transfers risk in whole or in part to another organisation – e.g. taking a professional indemnity insurance to *inter alia* cover the potential risk of liability resulting from any breach of a provision of the relevant requirements which apply to the Licence Holder and any administrative penalty resulting from such breach.

[C] Risk Financing refers to the mechanisms for funding the financial consequences of risk - e.g. increasing the Own Funds to provide for compliance risk, which risk is not catered for in the Automated COREP Return which Licence Holders are required to submit to the Authority on a periodic basis.

In order for a Licence Holder to assess the adequacy of its capital, the Licence Holder shall apply Risk Financing to treat those risks the impact of which can be calculated in its entirety. In this regard, the Licence Holder shall assess:

[a] whether the risks captured by the Pillar I capital requirement calculation, adequately reflect the actual size of the risks faced by the Licence Holder. In this regard, the Licence Holder is required to estimate the additional capital needed (if any) to protect its business operations from such risks; and

[b] the remaining risks which are not captured by the Pillar I regime – classified in section [I d] above as '*Other Possible Risks*' and where relevant, to estimate any additional capital requirements to mitigate such risks.

Further to the above assessment the Licence Holder shall carry out an **RMICAAP Risk Financing Calculation** by calculating the total risk capital component

required to mitigate the Total Gross Risk (i.e. the summation of all the Gross Risks to which the Licence Holder is exposed). In this regard, in making this calculation the Licence Holder shall use the table titled *RMICAAP – Risk Financing Calculation Report* which is outlined in the Annex to this Appendix.

[D] Additional technical criteria on the treatment of securitisation risk

For the purposes of the organisation and treatment of securitisation risk (referred to in Part A Section I [d 5]), the Licence Holder is required to evaluate and address the risks arising from securitisation transactions through appropriate policies and procedures, to ensure in particular that the economic substance of the transaction is fully reflected in the risk assessment and management decisions.

Liquidity plans to address the implications of both scheduled and early amortisation must exist at Licence Holders which are originators of revolving securitisation transactions involving early amortisation provisions.

[E] Additional technical criteria on the treatment of liquidity risk

[a] For the purposes of the organisation and treatment of liquidity risk (referred to in Part A Section I [d 1]), the Licence Holder is required to have robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of liquidity risk, over an appropriate set of time horizons, including intra-day, so as to ensure that adequate levels of liquidity buffers are maintained. The strategies, policies, processes and systems of the Licence Holder shall be tailored to business lines, currencies, branches and legal entities and shall include adequate allocation mechanisms of liquidity costs, benefits and risks.

[b] The strategies, policies, processes and systems referred to in paragraph [a] above shall be proportionate to the complexity, risk profile, scope of operation of the Licence Holder and risk tolerance set by the management body and reflect the Licence Holder's importance in each Member State, in which it carries out business. The Licence Holder shall communicate risk tolerance to all relevant business lines.

[c] The Licence Holder, taking into account the nature, scale and complexity of its investment services activities, shall establish liquidity risk profiles that are consistent with and, not in excess of, those required for a well-functioning and robust system.

[d] The Licence Holder is required to develop methodologies for the identification, measurement, management and monitoring of funding positions. These methodologies shall include the current and projected material cash-flows in and arising from assets, liabilities, off-balance sheet items, including

contingent liabilities and the possible impact of reputational risk.

- [e] The Licence Holder must distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. They shall also take into account the legal entity in which assets reside, the country where assets are legally recorded either in a register or in an account as well as their eligibility and shall monitor how assets can be mobilised in a timely manner.

- [f] The Licence Holder must also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the EEA.

- [g] The Licence Holder must consider different liquidity risk mitigation tools, including a system of limits and liquidity buffers in order to be able to withstand a range of different stress events and an adequately diversified funding structure and access to funding sources. Those arrangements shall be reviewed regularly.

- [h] Alternative scenarios on liquidity positions and on risk mitigants must be considered by the Licence Holder and the assumptions underlying decisions concerning the funding position shall be reviewed at least annually. For these purposes, alternative scenarios shall address, in particular, off-balance sheet items and other contingent liabilities, including those of Securitisation Special Purpose Entities or other special purpose entities, as referred to in the CRR, in relation to which the Licence Holder acts as sponsor or provides material liquidity support.

- [i] The Licence Holder is required to consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time periods and varying degrees of stressed conditions must also be considered.

- [j] The Licence Holder should adjust their strategies, internal policies and limits on liquidity risk and develop effective contingency plans, taking into account the outcome of the alternative scenarios referred to in paragraph [h] above.

- [k] In order to deal with liquidity crises, the Licence Holder must have in place liquidity recovery plans setting out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls, including in relation to branches established in another Member State. Those plans should be regularly tested, at least annually, updated on the basis of the outcome of the alternative scenarios set out in paragraph [h] above, be reported to and approved by senior management, so that internal policies and processes can be adjusted accordingly. Licence holders shall take the necessary operational steps in advance to ensure that liquidity recovery plans can be

implemented immediately.

[F] Additional technical criteria on the treatment of remuneration risk

For the purposes of this Section:

“discretionary pension benefits” means enhanced pension benefits granted on a discretionary basis by the Licence Holder to an employee as part of that employee’s variable remuneration package, which do not include accrued benefits granted to an employee under the terms of the company pension scheme.

“remuneration bracket” refers to the range of the total remuneration of each of the staff members in the senior manager and risk taker categories – from the highest paid to the lowest paid in these categories.

“variable remuneration” refers to additional payments or benefits depending on performance or, in certain cases, other contractual criteria.

- [a] The Licence Holder is required to establish and apply the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile.
- [b] The Licence Holder must be able to demonstrate to the MFSA how it has assessed and selected Identified Staff, in accordance with [EBA Final draft regulatory technical standards](#).
- [c] When establishing and applying the total remuneration policies, the Licence Holder must comply with the following principles in a way and to the extent that is appropriate to its size, internal organisation and the nature, the scope and the complexity of its activities:
 - (i) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the Licence Holder;
 - (ii) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the Licence Holder, and incorporates measures to avoid conflicts of interest;
 - (iii) the Licence Holder’s management body in its supervisory function adopts and periodically reviews the general principles of the remuneration policy and is responsible for overseeing its implementation;

- (iv) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;
- (v) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;
- (vi) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in paragraph [d] below or, if such a committee has not been established, by the management body in its supervisory function;
- (vii) the remuneration policy, taking into account national criteria on wage setting, makes a clear distinction between criteria for setting:
 - (a) basic fixed remuneration, which should primarily reflect relevant professional experience and organisational responsibility as set out in an employee's job description as part of the terms of employment; and
 - (b) variable remuneration which should reflect a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment.
- (viii) In the case of a Licence Holder that benefits from exceptional government intervention:
 - (a) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;
 - (b) the MFSA requires the Licence Holder to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the members of the management body of the Licence Holder;
 - (c) no variable remuneration is paid to the members of the management body of the Licence Holder unless justified;
- (ix) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the

performance of the individual and of the business unit concerned and of the overall results of the Licence Holder and when assessing individual performance, financial and non-financial criteria are taken into account;

- (x) the assessment of the performance is set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the Licence Holder and its business risks;
- (xi) the total variable remuneration does not limit the ability of the Licence Holder to strengthen its capital base;
- (xii) guaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and shall not be a part of prospective remuneration plans;
- (xiii) guaranteed variable remuneration is exceptional, occurs only when hiring new staff and where the Licence Holder has a sound and strong capital base and is limited to the first year of employment;
- (xiv) fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component;
- (xv) the Licence Holder must set the appropriate ratios between the fixed and the variable component of the total remuneration, whereby the following principles shall apply:
 - (a) the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual;
 - (b) shareholders or owners or members of the Licence Holder may approve a higher maximum level of the ratio between the fixed and variable components of remuneration provided the overall level of the variable component shall not exceed 200 % of the fixed component of the total remuneration for each individual.

Any approval of a higher ratio in accordance with (xv)(a) shall be carried out in accordance with the following procedure:

- the shareholders or owners or members of the Licence Holder shall

act upon a detailed recommendation by the Licence Holder giving the reasons for, and the scope of, an approval sought, including the number of staff affected, their functions and the expected impact on the requirement to maintain a sound capital base;

- shareholders or owners or members of the Licence Holder shall act by a majority of at least 66 % provided that at least 50 % of the shares or equivalent ownership rights are represented or, failing that, shall act by a majority of 75 % of the ownership rights represented;
 - the Licence Holder shall notify all shareholders or owners or members of the Licence Holder, providing a reasonable notice period in advance, that an approval under the first subparagraph of this paragraph will be sought;
 - the Licence Holder shall, without delay, inform the MFSA of the recommendation to its shareholders or owners or members, including the proposed higher maximum ratio and the reasons therefore and shall be able to demonstrate to the MFSA that the proposed higher ratio does not conflict with the Licence Holder's obligations under the Investment Services Rules and the CRR, having regard in particular to the Licence Holder's own funds obligations;
 - the Licence Holder shall, without delay, inform the MFSA of the decisions taken by its shareholders or owners or members, including any approved higher maximum ratio pursuant to the first subparagraph of this paragraph, and the MFSA shall use the information received to benchmark the practices of Licence holders in that regard. The MFSA shall provide this information to EBA.
 - staff who are directly concerned by the higher maximum levels of variable remuneration referred to in this paragraph shall not, where applicable, be allowed to exercise, directly or indirectly, any voting rights they may have as shareholders or owners or members of the Licence Holder;
- (c) Licence Holders may apply the discount rate referred to in article 94 (1) (g) (iii) of the CRD to a maximum of 25 % of total variable remuneration provided it is paid in instruments that are deferred for a period of not less than five years.

Licence Holders should make reference to [EBA's consultation paper](#) for further guidance on how the notional discount rate should be

applied.

Licence Holders shall be required to apply the principles in this paragraph (xv) to remuneration awarded for services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 1 January 2014.

- (xvi) payments relating to the early termination of a contract reflect performance achieved over time and are designed in a way that does not reward failure or misconduct;
- (xvii) remuneration packages relating to compensation or buy out from contracts in previous employment must align with the long-term interests of the Licence Holder including retention, deferral, performance and clawback arrangements;
- (xviii) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required;
- (xix) the allocation of the variable remuneration components within the Licence Holder shall also take into account all types of current and future risks;
- (xx) a substantial portion, and in any event at least 50 %, of any variable remuneration must consist of an appropriate balance of:
 - (a) shares or equivalent ownership interests, subject to the legal structure of the Licence Holder concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed Licence Holder, and
 - (b) where possible, other instruments within the meaning of articles 52 or 63 of the CRR or other instruments that can be fully converted to Common Equity Tier 1 instruments or written down, that in each case adequately reflect the credit quality of the Licence Holder as a going concern and are appropriate to be used for the purposes of variable remuneration.

Licence Holders should refer to [EBA's Consultation Paper on the Draft Regulatory Technical Standards](#) to determine the classes of instruments that are appropriate to be used for the purposes of variable remuneration.

The instruments referred to in this paragraph must be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the Licence Holder. The MFSA may place restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate. This paragraph shall be applied to both the portion of the variable remuneration component deferred in accordance with point (xxi) and the portion of the variable remuneration component not deferred;

- (xxi) a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.

Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

- (xxii) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the Licence Holder as a whole, and justified on the basis of the performance of the Licence Holder, the business unit and the individual concerned.

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the Licence Holder occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements;

Up to 100 % of the total variable remuneration shall be subject to malus or clawback arrangements. Licence Holders shall set specific criteria for the application of malus and clawback. Such criteria shall in particular cover situations where the staff member:

- (a) participated in or was responsible for conduct which resulted in significant losses to the Licence Holder;
- (b) failed to meet appropriate standards of fitness and propriety;

- (xxiii) the pension policy is in line with the business strategy, objectives, values and long-term interests of the Licence Holder.

If the employee leaves the Licence Holder before retirement, discretionary pension benefits must be held by the Licence Holder for a period of five years in the form of instruments referred to in point (xx). In case of an employee reaching retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (xx) subject to a five-year retention period;

(xxiv) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

(xxv) variable remuneration is not paid through vehicles or methods that facilitate the avoidance of the requirements of the Act, Investment Services Rules or the CRD and the CRR.

[d] The Licence Holder which is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities, shall establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgement on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

The remuneration committee shall be responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the Licence Holder concerned and which are to be taken by the management body. The Chairperson and the members of the remuneration committee shall be members of the management body who do not perform any executive function in the Licence Holder concerned. If employee representation on the management body is provided for by Maltese law, the remuneration committee shall include one or more employee representatives. When preparing such decisions, the remuneration committee must take into account the long-term interests of shareholders, investors and other stakeholders in the Licence Holder and the public interest.

For the purposes of determining whether a Licence Holder is to be considered significant, the Authority shall apply SLCs 1.55 to 1.58 inclusive of Part BI.

The principles set out in Section F (a) – (d) above shall be applied by the Licence Holder at group, parent company and subsidiary levels, including those established in offshore financial centres.

[G] Additional technical criteria on the treatment of market risk

[a] Policies and processes for the identification, measurement and management of all material sources and effects of market risks shall be implemented.

[b] Where the short position falls due before the long position, the Licence Holder shall ensure that it takes measures against the risk of a shortage of liquidity.

[c] The internal capital shall be adequate for material market risks that are not subject to an own funds requirement.

The Licence Holder which has, in calculating own funds requirements for position risk in accordance with Part Three, Title IV, Chapter 2, of the CRR, netted off its positions in one or more of the equities constituting a stock-index against one or more positions in the stock-index future or other stock-index product shall have adequate internal capital to cover the basis risk of loss caused by the future's or other product's value not moving fully in line with that of its constituent equities. The Licence Holder shall also have such adequate internal capital where it holds opposite positions in stock-index futures which are not identical in respect of either their maturity or their composition or both.

Where using the treatment in article 345 of the CRR, the Licence Holder shall ensure that it holds sufficient internal capital against the risk of loss which exists between the time of the initial commitment and the following working day.

[H] Additional technical criteria on the treatment of interest rate risk in the banking book

The Licence Holder shall implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect the non-trading activities of the Licence Holder.

[I] Additional technical criteria on the treatment of operational risk

The Licence Holder shall implement policies and processes to evaluate and manage the exposure to operational risk, including model risk², and to cover low-frequency high-severity events. The Licence Holder shall specify what constitutes operational risk for the purposes of those policies and procedures.

In addition, the Licence Holder shall ensure that contingency and business continuity plans are in place to ensure the Licence Holder's ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

² Model risk means the potential loss an institution may incur, as a consequence of decisions that could be principally based on the output of internal models, due to errors in the development, implementation or use of such models.

[J] Additional technical criteria on the treatment of the risk of excessive leverage

The Licence Holder shall have policies and processes in place for the identification, management and monitoring of the risk of excessive leverage.

The Licence Holder shall address the risk of excessive leverage in a precautionary manner by taking due account of potential increases in the risk of excessive leverage caused by reductions of the Licence Holder's own funds through expected or realised losses, depending on the applicable accounting rules. To that end, the Licence Holder shall be able to withstand a range of different stress events with respect to the risk of excessive leverage.

Indicators for the risk of excessive leverage shall include the leverage ratio determined in accordance with article 429 of the CRR and mismatches between assets and obligations.

In this regard, a Category 3 Licence Holder is required to complete the Leverage Ratio Templates, which are included in the automated COREP Return, by making reference to the [European Commission's Instructions on Leverage](#) (Annex XI to the draft ITS on supervisory reporting).

By way of derogation from articles 429 and 430 of the CRR, during the period between 1 January 2014 and 31 December 2021, Category 3 Licence Holders shall calculate and report the leverage ratio by using both of the following as the capital measure:

[a] Tier 1 capital;

[b] Tier 1 capital, subject to the derogations laid down in Chapters 1 and 2 of Title I of Part Ten of the CRR, as implemented in the Investment Services Rules.

[K] Additional technical criteria on the treatment of the credit/counterparty risk

For the purposes of managing credit/counterparty risk (referred to in Part A Section I [a 1]), the Licence Holder shall ensure that:

(i) credit-granting is based on sound and well-defined criteria and that the process for approving, amending, renewing, and re-financing credits is clearly established;

(ii) internal methodologies are established which enables assessment of the credit risk of exposures to individual obligors, securities or securitisation positions and credit risk at the portfolio level. In particular, internal methodologies shall not rely

solely or mechanistically on external credit ratings. Where own funds requirements are based on a rating applied through the Credit Quality Steps Approach or based on the fact that an exposure is unrated, this shall not exempt the Licence Holder from additionally considering other relevant information for assessing their allocation of internal capital;

(iii) the ongoing administration and monitoring of the various credit risk-bearing portfolios and exposures of the Licence Holder, including for identifying and managing problem credits and for making adequate value adjustments and provisions, is operated through effective systems;

(iv) diversification of credit portfolios is adequate given a Licence Holder's target markets and overall credit strategy.

[L] Additional technical criteria on the treatment of the residual risk

Residual risk (referred to in Part A Section I [d 9]) shall be addressed and controlled including by means of written policies and procedures.

[M] Additional technical criteria on the treatment of the concentration risk

The Licence Holder shall address and control the concentration risk arising from exposures to each counterparty, including central counterparties, groups of connected counterparties, and counterparties in the same economic sector, geographic region or from the same activity or commodity, the application of credit risk mitigation techniques, and including in particular risks associated with large indirect credit exposures such as a single collateral issuer, by means of written policies and procedures.

[VI] Risk Recording / Reporting

The Licence Holder is required to assess on a yearly basis whether its RMICAAP is comprehensive and proportionate to the nature, scale and complexity its activities, and to take any necessary measures to ensure this is the case.

Furthermore, on the 31st January of each calendar year, a Licence Holder is required to provide the Authority with a confirmation that it has an RMICAAP in place and that this is comprehensive and proportionate to the nature scale and complexity of the activities of the Licence Holder.

Lastly, a Licence Holder may be required by the Authority to submit an RMICAAP Report.

Given the above-quoted requirements, the Licence Holder shall keep a record of: **[i]** all the risks which it has identified, **[ii]** the estimation of such risks, **[iii]** its risk tolerance level and evaluation; and **[iv]** the manner in which these risks are being

addressed. In the case of Risk Financing, a record of the RMICAAP Risk Financing Calculation should also be retained. These records shall be updated on a yearly basis.

Should the Licence Holder be requested by the Authority to submit an RMICAAP Report, the Licence Holder would be expected to submit a report in the suggested format set out in the Annex to this Appendix i.e. a report on: **[a]** the Licence Holder's risk identification and monitoring process – i.e. a general overview of the arrangements and processes implemented by the Licence Holder with the aim of identifying and monitoring its risks; **[b]** the individual risks to which the Licence Holder is exposed; and **[c]** an RMICAAP Risk Financing Calculation Report. The Licence Holder should use the Specimen RMICAAP Report in order to keep a record of: **[a]** its risk identification and monitoring process; **[b]** all the risks which it has identified; and **[c]** the RMICAAP Risk Financial Calculation.

Annex**SPECIMEN RMICAAP – Report**

Name of Licence Holder	ABC Investment Services Limited
Date of Compilation	31 January 2014
Contents	Section I – Risk Identification and Monitoring Process Section II - RMICAAP Report on the individual risks Section III – RMICAAP Risk Financing Calculation Report

Section II - RMICAAP Report on the individual risks

Name of Risk	E.G. Compliance Risk – Late submission of documents
Nature of the Risk	The risk of legal or regulatory sanctions, financial loss, or reputational impact due to a failure to comply with the financial reporting requirements set out in the applicable MFSA Rules: i.e. late submission of financial returns.
Risk Estimation	<p>Quantitative Impact: ABC Investment Services Limited could be subject to [i] an initial fine amounting to between € 58.23 and € 114.69; and [ii] possibly a daily fine amounting to between € 11.65 and € 69.88.</p> <p>Qualitative Impact: MFSA name and shame policy (impact cannot be quantified).</p> <p>Probability: The accounting department of ABC Investment Services Limited is currently understaffed and therefore the probability of late submission of the Automated COREP Return is High.</p>
Risk Tolerance	ABC Investment Services Limited considers its reputation as fundamental for its business and therefore classifies its reputational risk tolerance as low.
Risk Treatment	<p>E.G. Risk control</p> <p>Short Term: The General Manager of ABC Investment Services Limited has agreed with the accounts official to work over-time in order to be in a position to submit the financial return on the due date.</p> <p>Long Term: The Board of Directors of ABC Investment Services Limited has decided that within the next year the staff complement of the accounts department should be increased.</p>

Section III - RMICAAP – Risk Financing Calculation Report

RMICAAP – Risk Financing Calculation Report E.g. For a Category 2 Investment Services Licence Holder	<i>As reported in the Annual COREP Return</i>	<i>Gross Risks as calculated by the Licence Holder further to the risk estimation process</i>
	<i>Euro</i>	<i>Euro</i>
<i>Pillar I Risks</i>		
Non-Trading Book Business Risks	50,000	50,000
Trading Book Business Risks	230	230
Commodities Risk	-	-
Large Exposures (Applicable to Cat 3)	10,000	15,000
Foreign Exchange Risk	2,000	2,000
Operational Risk (Applicable to Cat 3)	-	
<i>Total Risk</i>	62,230	67,230
<i>Other Possible Risks</i>		
Liquidity Risk		2,000
Compliance Risk		-
Technology Risk		-
Strategic Risk		-
Total RMICAAP Capital Requirement		69,230
Current total Own Funds (minimum Euro 125,000)		126,000
Surplus		56,770