MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular addressed to the investment services industry regarding the transposition of the Third Capital Requirements Directive ("CRD III")

11th May, 2012

The Capital Requirements Directive (CRD) is composed of two directives, the recast Banking Consolidation Directive 2006/48/EC and the recast Capital Adequacy Directive 2006/49/EC, which have been adopted by the Council of the European Union and the European Parliament on the 14th June 2006. The objective of the CRD is *inter alia* to ensure the financial soundness of credit institutions and investment firms.

During the years 2009 and 2010, the European Parliament and the EU Council approved key amendments to the CRD, which are referred to as the Second Capital Requirements Directive (CRD II) and the Third Capital Requirements Directive (CRD III). These aim to strengthen the stability of the financial system and seek to enhance the prudential supervision of credit institutions and investment firms.

On the 19th January, 2011 the MFSA published its amendments to the Investment Services Rules for Investment Services Providers ("the Rules") which incorporated the changes relating to the CRD II and part of CRD III. The transposition of CRD II in the Rules related mainly to: **[i]** the applicability of the large exposures requirement to category 3 investment services licence holders; **[ii]** the eligibility of hybrid capital instruments as tier one capital in the calculation of the investment services licence holders' own funds; and **[iii]** the introduction of a new exposure class for credit risk, with regards to EEA Financial Services Licensed Entities and corporates for which a short term credit rating has been issued. The requirement for investment services licence holders to have a remuneration policy and the applicability of the Pillar III disclosures on remuneration policy and practices resulted from the transposition of part of CRD III.

The purpose of this circular is to provide the investment services industry with: **[i]** a brief outline of the amendments effected to transpose the requirements of CRD III which had remained outstanding; and **[ii]** the manner in which the Authority has transposed the outstanding CRD III amendments in the Rules; and **[iii]** an indication of the applicability of the Guidelines issued by the European Banking Authority (EBA) on this subject.

Part I – Outline of the Requirements in CRD III which are being transposed

The outstanding provisions of Directive 2010/76/EU (which is commonly referred to as CRD III) need to be transposed into the local legislative framework. These include: **[i]** the applicability of the provisions on prudent valuation in Directive 2006/49/EC to all instruments measured at fair value; **[ii]** the imposition of capital requirements for the settlement risks arising from the non-trading book; **[iii]** the strengthening of the disclosure requirements of financial institutions with regards to the risks of securitisation positions; and

[iv] higher capital requirements with respect to the calculation of market risk based on internal models.

Part II – The transposition of the outstanding provisions of the CRD III in the local legislative framework, applicable to investment services licence holders

The transposition of the provisions of Directive 2010/76/EU which relate to the matters referred to in Part I above, has been made by way of the following amendments to the Rules as indicated in [A] below as well as the adoption of the Investment Services Act (Financial Capital Adequacy Consolidation) (Amendment) Regulations, 2012 also referred to in [B] below.

A. Amendment to the Investment Services Rules

A.I Amendments to Part BI of the Rules

In Part BI of the Rules the following amendment has been made:

Amendment to SLCs 7.49: The scope of the disclosures referred to as Pillar 3 disclosures, has been increased to include the appropriate disclosure of the Licence Holder's risk profile to market participants. This extended disclosure requirement is not applicable to Licence Holders which are exempt from complying with SLC 7.49, i.e.

a. Credit institutions which are also Licence Holders;
b. Category 1 Licence Holders;
c. Licence Holders which only provide management services to collective investment schemes; and
d. Companies which are only licensed under the Investment Services Act, 1994 as Category 4 Licence Holders.

Providing that with respect to (c) above, the MFSA may, on a case by case basis, exempt Licence Holders providing other services apart from fund management, from the requirements of SLC 7.49.

A.2 Amendments to Appendix 1 to Part B of the Rules.

In **Appendix 1** to Part B of the Rules the following amendments have been made:

Sections 1.2, 1.3.3, 4.2.2.2, 4.2.2.3, 4.2.2.4 and new Sections 1.3.8 and 4.2.7: As a result of the CRD III , the Licence Holder's obligation to calculate the capital requirement for the settlement risk component shall apply to all the business activities of the Licence Holder and not only to trading book activities.

Accordingly, Section 4.2.2.2 has been deleted and the capital requirement relating to settlement risk has been transferred to a new Section 4.2.7. Sections 4.2.2.3 (*Counterparty Risk Component)* and 4.2.2.4 *(Free Deliveries)* have been re-numbered Sections 4.2.2.2 and 4.2.2.3 respectively.

This particular amendment is not applicable to Fund Managers.

Section 2.3.3: The new Rules require the Licence Holder who has a trading book to include guidelines in its documented policies and procedures relating to the valuation of items where inputs to the valuation are not observable.

Where it is not possible for the Licence Holder to mark its positions to market, the Licence Holder is expected to mark to model its positions *'conservatively'*. The purpose of this amendment is to indicate that the valuations derived from marking to model should, for regulatory purposes, be conservative.

The reference to *'Procedures for considering valuation adjustments/reserves'* has been amended to *'Procedures for considering valuation adjustments'* in order to indicate that an adjustment is required under the prudent valuation framework, rather than a reserve.

The Licence Holder is also required to establish and maintain procedures for calculating an adjustment to the current valuation of less liquid positions. Such adjustments shall where necessary be in addition to those used in the Licence Holder's financial statements.

Another amendment relates to the model risk arising in the valuation of complex products, such as securitisation exposures and nth-asset-to-default credit derivatives. In this regard, the Licence Holder is required to consider the need for valuation adjustments to reflect the model risk associated with using a valuation which may be incorrect and the risk from using unobservable calibration parameters in the valuation model.

The amendments to this Section are not applicable to Fund Managers.

Section 4.1.1 (E) and Section 4.1.2 (C): Further to the transposition of the CRD III relating to the valuation of positions, the prudent valuation framework, which is included in Section 2.3.3 (a) to (d) of Appendix 1, shall also be applicable to all fair-valued positions (including non-trading book assets), when calculating the amount of own funds. Any additional value adjustments necessary must be deducted from total tier one capital after deductions.

Section 4.1.2 (D): This section stipulates the deductions from tier two capital and includes a sub-section on *'Securitisation exposures not included in risk weighted assets'*. This section has been amended to include the deduction of the exposure amount of securitisation positions in the trading book.

Section 4.2.1.1: This section which deals with the calculation of the credit/counterparty risk component using the Standardised Approach was amended to clarify the treatment of exposures to regional governments and local authorities. These exposures may be treated as either a class 2 or a class 3 exposure. Where the exposures to the Member States' regional government and local authority are denominated and funded in the domestic currency of that regional government and local authority, these exposures shall be assigned a risk weight of 20%.

Section 4.2.1.1 is not applicable to Fund Managers.

Section 4.2.2.1: This section deals with the calculation of the position risk component of financial instruments which qualify as trading book business. Particular reference has been made to the Licence Holder's option to measure the position risk component through its own internal risk-management model. The new requirements for adopting an internal model are

included in a new Annex (Annex IX – Use of Internal Models to calculate Capital Requirements).

Additional amendments have been made to Section 4.2.2.1, by specifically including two new sub-headings: **[i]** *Traded Debt Instruments: Specific Risk for Securitisation Positions*; and **[ii]** *Traded Debt Instruments: Specific Risk for the Correlation Trading Portfolio*.

Traded Debt Instruments: Specific Risk for Securitisation Positions

The European Commission had a regulatory concern relating to the possibility of regulatory arbitrage with respect to the lower capital requirements that were applicable to positions held in the trading book, in contrast to securitisation positions held in the non-trading book. This concern was addressed in the CRD III by aligning the capital requirements relating to securitisation positions in the trading book with the capital requirements applicable to securitisation positions held in the non-trading book.

Traded Debt Instruments: Specific Risk for the Correlation Trading Portfolio

Specific rules on capital requirements have been set in relation to the correlation trading activities that are undertaken by financial institutions in the trading book. A definition of the correlation trading portfolio is provided in Section 4.2.2.1 itself.

Lastly, the Licence Holder is now allowed to cap the capital requirement for positions in traded debt instruments, including securitisation and correlation trading positions at the maximum possible default-risk-related loss for that position.

An amendment has also been made to the specific risk factor of the position risk component of an equity instrument, where the capital requirement has been increased to 8%.

Section 4.2.2.1 is not applicable to Fund Managers.

Sections 4.2.3, 4.2.5: The commodities risk component and the foreign exchange risk component can also be measured through the Licence Holder's own internal risk-management model. As indicated above, the requirements for adopting an internal model are included in a new Annex (Annex IX – Use of Internal Models to calculate Capital Requirements).

Sections 4.2.3 and 4.2.5 are not applicable to Fund Managers.

Annex IB: An amendment has been made to the 'marking to market' method, which is one of the four methods that may be used by the Licence Holder to determine the exposure value of over-the-counter derivative instruments, for the purpose of calculating the counterparty credit risk component.

Under the 'marking to market' method, the Licence Holder must calculate the potential future credit exposure, which in the case of credit derivatives, is either 5% or 10% of the nominal amount of the instrument, depending on whether a direct exposure to the underlying reference name would meet the definition of a qualifying debt security. This amendment limits the potential future credit exposure for credit default swaps to the present value of the future premiums owed by the swap counterparty.

Annex IB is not applicable to Fund Managers.

Annex V: The main change to this Annex is the application of higher risk weights to re-securitisation positions, in order to reflect the higher risk associated with these positions. A definition of the term *'re-securitisation'* and *'re-securitisation position'* is provided at the end of this Annex. This Annex is not applicable to Fund Managers.

Annex VI: The cross-reference in point 1.2.2 of Section I.2 which relates to the treatment of the valuation adjustments that are taken against counterparty credit risk exposures has been included in point 4.1.0 of Section I.2. This amendment clarifies that Licence Holders which calculate the credit risk component by using the Internal Ratings Based Approach may use credit valuation adjustments taken against counterparty credit risk exposures to offset expected losses. The requirements of Annex VI are not applicable to Fund Managers.

Annex VII: Section 3 of this Annex relates to the calculation of the position risk component of credit derivatives where the Licence Holder is the protection seller (i.e. where the Licence Holder assumes the credit risk). Further to these amendments, the Licence Holder is provided with the option of calculating the position risk component by using the notional value less any market value changes of the credit derivative since trade inception, instead of just using the notional value. In addition, the treatment of a rated nth-asset-to-default credit derivative is also clarified. The requirements of Annex VII are not applicable to Fund Managers.

Annex IX: As indicated above, this is a new Annex which deals with the calculation of the position risk component, the foreign exchange risk component and/or the commodities risk component using the Licence Holder's own internal risk-management model. The requirements on internal models which are set in Directive 2006/49/EC have been amended through Directive 2010/76/EU. The main changes relate to: **[i]** the weekly calculation of the 'stressed value-at-risk'; **[ii]** the application of the incremental default and migration risk charge to traded debt instruments; and **[iii]** the introduction of an all price risk measure with a capital floor of 8% for the correlation trading portfolio.

A.3 Amendments to Appendix 4 of Part B of the Rules.

In **Appendix 4** of Part B of the Rules, the disclosure requirements for Licence Holders have been mainly updated with two new requirements: [i] Section 1.2.8 deals with the disclosure requirements relating to the securitisation risk exposures; and [ii] Section 1.5 deals with the disclosures applicable to Licence Holders which use their own internal risk-management model. In this regard, Licence Holders are required to disclose information relating to the incremental default and migration risk charge (which are set out in point 5a of Annex IX of Appendix 1) and the application of an all price risk measure with respect to the correlation trading portfolio (as required in terms of point 5l of Annex IX of Appendix 1).

The new Sections in Appendix 4 are not applicable to Fund Managers.

All the above amendments to the Rules come into force on the date of this circular. However, with regards to the practical implementation, the rules which set requirements that necessitate a change to the financial returns shall come into force on the date when the MFSA will issue the updated financial returns. *Investment Services Act (Financial Capital Adequacy Consolidation) (Amendment) Regulations, 2012.*

Directive 2010/76/EU provides an amendment to Article 136 of Directive 2006/48/EC which relates to the measures available to the competent authorities in the case where investment firms do not meet the requirements of the CRD.

It is the intention of the Authority to transpose this amendment by way of the Investment Services Act (Financial Capital Adequacy Consolidation) (Amendment) Regulations, 2012. These regulations will amend the Schedule which is included in the Investment Services Act (Financial Capital Adequacy Consolidation) Regulations, 2011 and are expected to be issued shortly.

Part III - Guidelines issued by the European Banking Authority (EBA)

For the purposes of transposing the provisions of CRD III in the Rules, the Authority has made specific reference therein to the guidance issued by EBA as follows:

a. Draft guidelines issued on the 30th November 2011 relating to the calculation of the incremental default and migration risk charge of traded debt instruments and the calculation of the stressed value-at-risk. Specific reference to these guidelines is made in points 5j and 9a of Annex IX of Appendix 1, respectively.

b. The EBA Guidelines on Internal Governance issued on the 27th September 2011which update the former guidelines on internal governance that were issued by the predecessor of EBA, the Committee of European Banking Supervisors. Specific reference to these guidelines is made in Appendix 10 of the Rules.

c. The EBA Guidelines on the Advanced Measurement Approach (AMA) to Operational Risk, issued on the 6th January 2012, provide guidance on how institutions may communicate AMA extensions and changes to the competent authorities and on how to define internal policies for AMA extensions and changes (AMA Change Policy) in line with supervisory expectations. Specific reference to these guidelines is made in Section 4.2.6 of Appendix 1, which encourages Licence Holders to consider these guidelines, where relevant.

Licence Holders may have access to the EBA guidelines through the following link: http://www.eba.europa.eu/Publications/Standards-Guidelines.aspx

Contacts:

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