

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular regarding the EU Capital Requirements Directive ('CRD')

6th December 2006

This Circular is being addressed to Investment Services Licence Holders subject to financial resources requirements in terms of the MFSA's Investment Services Guidelines, with a copy to their auditors for information.

The MFSA invites comments by not later than the 10th January, 2007 on the draft New Section 7 of Part C.I of the Investment Services Guidelines (to be renamed 'Rules') and Appendix I thereto attached to this document. Interested parties are to send their comments in writing addressed to the Director – Securities Unit, MFSA.

N.B. As explained in MFSA's circular regarding the EU Markets in Financial Instruments Directive dated 13th November 2006, the MFSA plans to adopt Part C I of the Investment Services Rules including the new Section 7 on the 31st January 2007, which rules will be brought into force on the 1st November 2007. In the meantime, Section 10 of Part C I of the current Investment Services Guidelines [a copy of which may be provided upon request] and Appendix I thereto will be amended to mirror the provisions of the New Section 7 and the New Appendix I attached to this document, duly up-dated as may be necessary following this consultation.

The planned applicability date for Investment Services Licence Holders of the above-mentioned revised Section 10 of Part C.I of the Investment Services Guidelines and the revised Appendix I thereto, is the 31st January, 2007.

The applicable planned time frames have been summarised in the following table:

Date	Investment Services Guidelines	Investment Services Rules
31 st January 2007	Bringing into force of the revised: [a] Part C I of the Investment Services Guidelines, as amended to include the version of Section 10 which mirrors Section 7 of Part C I of the Investment Services Rules; and [b] to the Guidelines.	Adoption of the Investment Services Rules part of which have the purpose of transposing the MiFID and the CRD. These Rules will come into force on the 1st November 2007.
1 st November 2007	Investment Services Guidelines are repealed.	Investment Services Rules brought into force.

1.0 Background

On the 21st August 2006, the MFSA issued the **1st Circular** on the EU Capital Requirements Directive, the main purpose of which was to draw investment services Licence Holders' attention to the upcoming implementation of the CRD and the MFSA's plans in this regard. As explained in the said circular, '*[t]he CRD lays down capital adequacy requirements applying to investment firms and credit institutions, the rules for their calculation and the rules for their prudential supervision, enabling competent authorities to evaluate the adequacy of such entities' own funds, having regard to the risks to which they are exposed.*'

The purpose of this **2nd Circular** on CRD is that of serving as a **Consultation** document outlining the proposed amendments to the Investment Services Guidelines which will provide for the transposition of this EU Directive. In particular, this circular briefly outlines:

- [a] the approach taken by the MFSA Securities Unit in transposing the CRD;
- [b] the new financial resources requirement; and
- [c] the principal changes which will be made to the Investment Services Guidelines with the purpose of transposing the CRD requirements and the applicability time-frame.

2.0 MFSA Securities Unit - CRD Transposition Approach

The CRD is a very technical and complex EU Directive. Indeed, the methodology for calculating certain features of the risk components of the CRD is very detailed. With the aim of facilitating the implementation of this EU Directive for MFSA's Investment Services Licence Holders as much as possible, the MFSA Securities Unit has in transposing the CRD, sought to simplify and tailor certain features of the CRD requirements to make them more appropriate for small and medium sized firms whose investment portfolios do not generally include the more sophisticated financial instruments.

With the aim of achieving the above objective, those elements of the various CRD risk components which refer to financial instruments which from experience, generally do not form part of the portfolio of investments of Licence Holders, have been omitted from the draft rules. In this regard, the MFSA has taken the approach that the requirements and the calculation of the risks related to investments in derivatives should, in the main, be dealt with on a case by case basis. Licence Holders who invest in derivatives should contact the MFSA for guidance as to how the aspects of the risk components which relate to these instruments should be dealt with. Moreover, the MFSA will be automating as much as possible, the new financial return which Licence Holders will be required to submit. As indicated in 4.1 below, this is currently being compiled.

3.0 The new Financial Resources Requirement

Whereas Licence Holders are currently required to maintain financial resources requirements relating to 'own funds' and 'liquid capital', the new financial resources requirement (SLC 7.01/7.02 refer), provides that Licence Holders are required at all times to maintain **own funds** which are equal to or in excess of their **capital resources requirement**. In turn, the **capital resources requirement** (which varies depending on the category of the Licence Holder), is spelt out in the new Appendix I to the Investment Services Guidelines. The following tables summarise the capital resources requirement which Licence Holders will be required to satisfy:

Table I - Category 1a, 1b, Category 2, and Category 4

The Capital Resources Requirement shall be the higher of (i) and (ii) below:	
[i]	Initial Capital ¹
[ii]	The higher of the following: <ul style="list-style-type: none">(a) the sum of the non-trading book business risk components, the trading book business risk components, the commodities instruments risk component, the large exposures risk component, and the foreign exchange risk component;(b) the fixed overheads requirement.

Table II - Category 3

The Capital Resources Requirement shall be the higher of (i) and (ii) below:	
[i]	Initial Capital ²
[ii]	the sum of the non-trading book business risk components, the trading book risk components, the commodities instruments risk component, the large exposures risk component, the foreign exchange risk component, and the operational risk component.

4.0 Principal Changes to the Investment Services Guidelines

4.1] General

The CRD rules are being transposed through:

[a] a revised Section 10 of Part C.I. of the Investment Services Guidelines which will mainly reflect section 7 of Part C I of the Investment Services Rules. The SLCs in the current **section 10** of Part C I of the Investment Services Guidelines will, in the new Rules, be divided between the new **Section 7 – Financial Reporting and Record Keeping** (i.e. the **up-dated SLCs in the current Section 10, excluding SLC 10.39 to SLC 10.41 which deal explicitly with transaction reporting**) and the new **Section 8 – Transaction Reporting** (which will replace SLCs 10.39 to 10.41).

¹ Please refer to section 1.3.1 of the draft new Appendix I of the Investment Services Guidelines for the definition and levels of ‘initial capital’ per Category of Licence Holder.

² Vide Footnote 1 above.

This circular deals with the SLCs which will form part of the new **Section 7**. The proposed new Section 8 of the Investment Services Rules relating to Transaction Reporting, will be the subject of a separate consultation document.

[b] a new Appendix I titled '*Financial Resources Requirements and Guidance on the compilation of the financial return*'; and

[c] a duly revised automated financial return.

N.B. Although the new Appendix I explains the manner in which Licence Holders should complete the automated financial return, the said Return is currently being compiled and will be the subject of a separate circular.

[4.2] Revised Section 10 of Part C I of the Investment Services Guidelines / New Section 7 of Part C I of the Investment Services Rules

The SLCs in the current Section 10 of Part C I of the Investment Services Guidelines which deal with **Financial Resources; Record Keeping and Reporting; Customers' accounting records; Financial Notification; Audit; and Supplementary Conditions for Licence Holders subject to the Investor Compensation Scheme Regulations** have been included in the **Section 7 of the proposed new rules**. In substance, other than the removal of references to the Liquid Capital Requirement (refer to section 3.0 above), no major changes are being proposed to the SLCs of the current Section 10.

The following are the salient changes from the current **Section 10** of the Investment Services Guidelines:

[a] **Insurance Principals and Category 5 ISLHs:** In view of the review of the regulatory regime relating to Linked Long-Term Contracts of Insurance, investment services Licence Holders which are also authorised to carry on the business of insurance as Principal under the Insurance Business Act, 1998, as well as Category 5 Investment Services Licence Holders, will be required to surrender their investment services licence by the end of this year. Accordingly, all references to these Licence Holders have been removed.

[b] **PII Requirement:** A slightly re-worded version of the professional indemnity insurance requirement which is presently found in SLC 1.06 of Part C I of the Investment Services Guidelines, is being included in Section 7;

[c] **Auditors' Report to the MFSA:** The wording of paragraph (e) (i) of the current SLC 10.32 of Part C I of the Investment Services Guidelines [new SLC 7.32] has been slightly amended in Section 7 to remove reference to the *reconciliations of Customers' Assets or Clients' Money*, which reconciliations will no longer be required at the level of the Investment Services Rules once the changes which are being made to transpose MiFID are brought into force.

N.B. – Applicability: As explained on page one of this document dealing with the consultation period. On the 31st January, 2007, the MFSA plans to adopt the New Section 7, which is being issued for consultation with this document, as part of Part C I the New Investment Services Rules, which rules will come into force on the 1st November 2007. In the meantime, Section 10 of Part C I of the current Investment Services Guidelines will be revised to mirror the provisions of the New Section 7 attached to this document, duly up-dated as may be necessary following this consultation. The

planned applicability date for Investment Services Licence Holders of the revised Section 10 of Part C.I of the Investment Services Guidelines is the 31st January, 2007.

4.3] Appendix I of Part C I of the Investment Services Guidelines/Rules

Appendix I of the Investment Services Guidelines, which contains the main provisions that transpose the CRD, is being amended considerably. The new Appendix I:

[a] details the new capital resources requirement;

[b] distinguishes between and explains the meaning of trading and non-trading book business;

[c] defines the various elements which make up the calculation of the Own Funds, each of the risk components, and the fixed overheads requirement; and

[d] explains the manner in which the automated financial return which Licence Holders are required to submit to the Malta Financial Services Authority in terms of the Investment Services Guidelines, should be completed.

The following is a brief outline of the main differences between the requirements set out in the current appendix I and those provided for in the attached proposed new version:

[A] Own Funds

Although no conceptual changes have been made to the methodology applied for the calculation of the Own Funds, the elements which make up this calculation have been divided into three tiers as follows:

Tier One Capital is made up of items of capital of a permanent nature, such as ordinary share capital, which during the liquidation of a company would rank for repayment after all other debts and liabilities.

Tier Two Capital consists of capital items that combine the features of debt and equity, i.e.: all items of capital which are structured like debt but exhibit some of the loss absorption and funding flexibility forms of equity.

Tier Three Capital consists of capital items which do not conform to the definition of tier one and two capital items.

[B] Risk Components

One of the major changes which will be brought about through the transposition of the CRD is the introduction of the distinction between trading book and non-trading book business. In terms of the new Appendix I, Licence Holders will be required to identify and categorise their assets into trading book business/non trading book business and investments in commodity instruments [including commodity derivatives].

[B.1] Trading Book Business – Risk Components

The New Appendix I defines the trading book business of a Licence Holder as consisting of all positions in financial instruments of a certain scale, which are either held with trading intent or to hedge other elements of the trading book. In terms of the same definition, the

trading book business shall also include all positions in derivative financial instruments whether or not these are held for trading.

The trading book business of the Licence Holder is subject, in terms of the new rules, to four risk components, being: [a] the position risk component; [b] the settlement risk component; [c] the counterparty risk component; and [d] free deliveries.

[i] The position risk component:

Position risk is defined as 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.

The application and calculation of position risk as provided for in the new Appendix I differs from the current position risk. In terms of the new Appendix I, position risk applies only to the trading business of the Licence Holder. Moreover, the methodology and risk weighting applied are different from those presently in force.

[ii] The settlement risk component:

Settlement risk is the risk that the Licence Holder's cash against documents transactions [delivery versus payment transactions] in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

The calculation of the settlement risk as provided for in the new Appendix I does not differ much from the current position. However, settlement risk in terms of the new Appendix I applies only to the Licence Holder's trading book business.

[iii] The counterparty risk component:

Counterparty risk for the purpose of trading book business is defined in the new rules as the amount of capital which the Licence Holder must hold against exposures in financial derivative instruments and credit derivatives.

[iv] Free deliveries:

Free Deliveries [non delivery versus payment transactions] 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.

The calculation of the free deliveries risk component as provided for in the new Appendix I does not differ much from the current position. However, the free deliveries risk component in terms of the new Appendix I only applies to the Licence Holder's trading book business.

[B.2] Non-trading book business – Risk Component

The assets of the Licence Holder which do not qualify as trading book business or commodity instruments [including commodity derivatives] will be subject, in terms of the new Appendix I, to the non-trading book business risk components, namely the **credit/counterparty risk component.**

Credit/counterparty risk component:

The credit/counterparty risk component, introduced for the first time in the new Appendix I, is the risk 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 non-trading book asset which forms part of the Licence Holder's balance sheet.

The credit/counterparty risk component is calculated through one of three methods, being: **[i]** the Standardised Approach, **[ii]** the Foundation Internal Ratings Based Approach [**FIRB**] or **[iii]** the Advanced Internal Ratings Based Approach [**AIRB**]. The New Appendix I only caters for the Standardised Approach. The FIRB and the AIRB [the latter approach will only be available after 1st January 2008] are based on the Licence Holder's assessments of the risks to which it is exposed. Upon request, MFSA will be providing guidance on these methods.

[B.3] Commodities Instruments - Risk Component

Commodities Risk, introduced for the first time in the new Appendix I, is the risk component required to cover the Licence Holder's risk of holding or taking positions in commodities) which are and can be traded in the secondary market, including commodity derivatives.

[B.4] Other Exposures – Risk Components

The following risk exposures apply to all the business activity of a Licence Holder.

[i] Large Exposures Risk Component:

The purpose of the large exposure requirement is to ensure that a firm manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirement.

The calculation of the large exposures risk component as provided for in the new Appendix I does not differ from the current position.

[ii] Foreign Exchange Risk Component:

This is 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.

The calculation of the foreign exchange risk component as provided for in the new Appendix I does not differ much from the current position.

[iii] Operational Risk Component:

Operational Risk, introduced for the first time in the new Appendix I and which is only relevant for Category 3 Licence Holders, is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

The operational risk capital requirement for a Licence Holder is equivalent to the amount calculated in accordance with one of the following methods: **[i]** the Basic Indicator Approach [**BIA**]; **[ii]** the Standardised Measurement Approach [**SMA**]; or **[iii]** the Advanced Measurement Approach [**AMA**]. The New Appendix I only caters for the **BIA**. Upon request, MFSA will be providing guidance on the other two approaches. However, as per the CRD, guidance on the **AMA** will only be made available after 1st January 2008.

[C] The Fixed Overheads Requirement

The calculation of this requirement as provided for in the new Appendix I does not differ much from the current position. However, the fixed overheads requirement in terms of the new Appendix I only applies to Category 1, 2 and 4 Licence Holders.

N.B. – Applicability: As explained on page one of this document dealing with the consultation period, the MFSA plans to adopt the New Appendix I, which is being issued for consultation with this document, as part of the New Investment Services Rules on the 31st January 2007 which rules will come into force on the 1st November 2007. In the meantime, Appendix I of the current Investment Services Guidelines will also be replaced by the proposed new Appendix I attached to this document, duly updated as may be necessary following this consultation. The planned applicability date for Investment Services Licence Holders of the revised Appendix I of the Investment Services Guidelines is the 31st January, 2007

5.0 Next Steps

As indicated in 4.1 above, the Financial Return which is presently being revised in line with the CRD requirements and which will complement the proposed new SLCs dealing with financial resources and reporting requirements and Appendix I to the Investment Services Guidelines, will be the subject of a separate circular, Licence Holders will be expected to start using the new Return for financial reporting to MFSA which falls due (i.e. having a reporting deadline) on or after 31st March, 2007.

Contacts

Should you have any queries regarding CRD please do not hesitate to contact:

Mr. Christopher Buttigieg
2548 5229
cbuttigieg@mfsa.com.mt

Mr. Konrad Farrugia
2548 5228
kfarrugia@mfsa.com.mt

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Draft Section 7 of Part C I of the New Investment
Services Rules setting financial resources and
reporting requirements applicable to Investment
Services Licence Holders

Target Date for Adoption: 31st January 2007

To be Effective: 1st November 2007

Financial Resources Requirements

- 7.01** The Licence Holder shall at all times maintain own funds equal to or in excess of its capital resources requirement. This shall constitute the Licence Holder's Financial Resources Requirement.

Provided that Licence Holders which are credit institutions licensed in terms of the Banking Act, 1994 or branches established in Malta of credit institutions authorised in a EU Member State or EEA State, or of overseas credit institutions which are subject to prudential requirements at least equivalent to the requirements applicable to Maltese credit institutions, are not subject to the above-mentioned financial resources requirement and need not prepare and submit any Interim or Annual Financial Return referred to in the SLCs which follow.

- 7.02** The meaning of own funds and the capital resources requirement applicable to the different categories of Licence Holders, as well as the methodology for calculating a Licence Holder's satisfaction of its Financial Resources Requirement, are set out in Appendix 1.
- 7.03** Licence Holders shall comply with any further financial resources requirements set by the MFSA. If the MFSA so determines, the Licence Holder will be given due notice in writing of the additional financial resources requirements which shall be applied.
- 7.04** The Licence Holder shall immediately advise the MFSA if at any time it is in breach of its Financial Resources Requirement. In this case, the MFSA may, if the circumstances justify it, allow the Licence Holder a limited period within which to restore its financial resources to the required level.

Professional Indemnity Insurance Requirement

- 7.05** The Licence Holder shall take out and maintain such insurance cover as it considers appropriate. The following mandatory requirements shall however apply:
- a.** Licence Holders (except for Category 1) shall be required to maintain such insurance policies of such classes and types to provide (unless otherwise agreed with the MFSA), at least the minimum level of protection set out in Appendix 7(B)).
 - b.** Category 1b Licence Holders having chosen the option to maintain professional indemnity insurance (instead of the option to comply with the financial resources and

reporting requirements applicable to Category 1a Licence Holders) shall take out and maintain professional indemnity insurance to provide at least the minimum level of protection set out in Appendix 7 (A).

Category 1b Licence Holders subject to the professional indemnity insurance requirement, shall submit a copy of their policy to the MFSA for approval, whilst Licence Holders falling under (a) above, shall submit a copy of their money policy to the MFSA for its approval.

For the purposes of demonstrating to the satisfaction of the MFSA that the requirements in (a) to (b) above are being complied with on an on-going basis, the Licence Holder shall within one month from the date of renewal of the policy submit to the MFSA, a copy of the renewal cover note or such other written evidence as the MFSA may require to establish compliance with these Rules.

A Licence Holder shall within two working days from the date he/she becomes aware of any of the circumstances specified in (a) to (g) below, inform the MFSA in writing where:

- a.** during the currency of a policy, the Licence Holder has notified insurers of an incident which may give rise to a claim under the policy;
- b.** during the currency of a policy, the insurer has cancelled the policy or has notified his intention of doing so;
- c.** the policy has not been renewed or has been cancelled and another policy satisfying the requirements of Appendix 7 has not been taken out from the day on which the previous policy lapsed or was cancelled;
- d.** during the currency of a policy, the terms or conditions are altered in any manner so that the policy no longer satisfies the requirements of Appendix 7;
- e.** the insurer has intimated that he intends to decline to indemnify the insured in respect of a claim under the policy;
- f.** the insurer has given notice that the policy will not be renewed or will not be renewed in a form which will enable the policy to satisfy the requirements of Appendix 7;
- g.** during the currency of a policy, the risks covered by the policy, or the conditions or terms relating thereto, are altered in any manner.

An Investment Services Licence Holder which is also licensed in terms of the Banking Act, 1994 and its subsidiaries, need not comply with the requirements of this Licence Condition, but instead shall provide MFSA with a brief summary of the nature and amount of its insurance cover.

Accounting / Record Keeping

- 7.06** The Licence Holder shall maintain proper accounting records to show and explain the Licence Holder's own transactions, assets and liabilities.
- 7.07** The accounting records shall:
- a. disclose with reasonable accuracy, at all times, the financial position of the Licence Holder; and
 - b. enable the financial statements required by the MFSA to be prepared within the time limits specified in the conditions of the Investment Services Licence.
- 7.08** In particular, the financial records shall contain:
- a. entries from day to day of all sums of money received and expended and the matters to which they relate;
 - b. a record of all income and expenses, explaining their nature;
 - c. a record of all assets and liabilities, including any guarantees, contingent liabilities or other financial commitments; and
 - d. entries from day to day of all transactions on the Licence Holder's own account.
- 7.09** The Licence Holder shall retain accounting records for a minimum period of ten years. During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.
- 7.10** The Licence Holder shall agree with the MFSA its Accounting Reference Date (financial year end).

Customers' accounting records

- 7.11** The Licence Holder shall ensure that proper accounting records are kept to show and explain transactions processed by the Licence Holder on behalf of its customers.
- 7.12** The records shall:
- a. record all purchases and sales of Customers' Assets processed by the Licence Holder;
 - b. record all receipts and payments of money belonging to customers which arise from transactions processed by the Licence Holder;
 - c. disclose the assets and liabilities of a Licence Holder's customers individually and collectively, to the extent that they are managed by the Licence Holder;
 - d. record all Customers' Assets (including title documents) in the possession of the Licence

Holder or of another person who is holding such assets for, or to the order of the Licence Holder, showing the location of the assets, their beneficial owner and the extent to which they are subject to any charge of which the Licence Holder has been notified.

- 7.13** Customers' accounting records shall be retained for a minimum period of ten years.

During the first two years they shall be kept in a place from which they can be produced within 24 hours of their being requested.

Reporting Requirements

- 7.14** Licence Holders shall provide the MFSA with all the information necessary for the assessment of their compliance with these rules. Licence Holders shall have internal control mechanisms and administrative and accounting procedures which permit the verification of their compliance with these rules.

- 7.15** Licence Holders shall in each year prepare an Annual Financial Return in the form set out in Appendix 2 signed by the proprietor where the Licence Holder is a sole trader, or otherwise by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Licence Holder is expected to provide a certified true copy of such Board Resolution to the MFSA.

- 7.16** The Annual Financial Return shall be submitted to the MFSA within one month of the Accounting Reference Date.

- 7.17** Audited annual financial statements prepared in accordance with International Financial Reporting Standards, together with a copy of the auditors' management letter and the auditors' report required by SLC 7.32, shall be submitted to the MFSA within four months of the Accounting Reference Date.

- 7.18** In addition to the Annual Financial Return and the audited annual financial statements, Category 1 Licence Holders shall prepare an Interim Financial Return, in the form set out in Appendix 2, at a date six months after the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the date for the preparation of the Interim Financial Return shall be agreed with the MFSA.

- 7.19** In addition to the Annual Financial Return and audited annual financial statements, Category 2 and Category 4 Licence Holders shall prepare an Interim Financial Return, in the form set out in Appendix 2, at dates three, six and nine months after the Accounting Reference Date. The first Interim Financial Return should cover the three months immediately following the Accounting Reference Date, the second Interim Financial Return should cover the six months immediately following the Accounting Reference Date and the third Interim Financial Return should cover the nine months immediately following the Accounting Reference Date. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA.

- 7.20** In addition to the Annual Financial Return and audited annual financial statements, Category 3 Licence Holders shall prepare an Interim Financial Return, in the form set out in Appendix

2, on a monthly basis. The first Interim Financial Return should cover the first month after the Accounting Reference Date, the second Interim Financial Return should cover first two months after the Accounting Reference Date and so on. In the event of a change to the Accounting Reference Date, the dates for the preparation of the Interim Financial Returns shall be agreed with the MFSA.

7.21 The Interim Financial Return shall be submitted to the MFSA within one month of the date up to which it has been prepared. It shall be signed by the proprietor where the Licence Holder is a sole trader, or otherwise by at least two directors or partners or any other persons authorised to sign by way of a Board Resolution. In the latter case, the Licence Holder is expected to provide a certified true copy of such Board Resolution to the MFSA.

7.22 The Licence Holder shall prepare and submit such additional financial returns as the MFSA may require.

7.23 The Licence Holder shall be responsible for the correct compilation of the financial returns. The nature and content of the financial returns shall be as follows:

- a. they shall be in the form set out in Appendix 2;
- b. they shall be in agreement with the underlying accounting records;
- c. accounting policies shall be consistent with those adopted in the audited annual financial statements and shall be consistently applied. These accounting policies should adequately cater for the following:
 - i. amounts in respect of items representing assets or income may not be offset against amounts in respect of items representing liabilities or expenditure, as the case may be, or vice versa, unless duly authorised by the MFSA; and
 - ii. balances representing clients' money and/ or assets held/ controlled by the Licence Holder must not form part of the Licence Holder's Balance Sheet;
- d. information to be included in the financial returns shall be prepared in accordance with International Financial Reporting Standards;
- e. investments shall be included in the balance sheet at valuations arrived at in accordance with the provisions of International Financial Reporting Standards;
- f. financial returns shall not be misleading as a result of the misrepresentation or omission or miscalculation of any material item;
- g. where the Annual Financial Return has been submitted before the relevant audited annual financial statements have been produced it shall be updated to reflect the information in the audited financial statements and submitted to the MFSA together with the audited annual financial statements;
- h. in the case of an individual or individuals in partnership or association, financial returns

shall be prepared to show relevant figures for the Investment Services business exclusively. If required by the MFSA to do so, the individual (or individuals) shall submit, in addition, a statement of personal assets and liabilities.

7.24 If so notified in writing by the MFSA, the Licence Holder shall be required to prepare and submit additional financial information for the purposes of consolidated supervision.

7.25 The Licence Holder shall notify the MFSA immediately it becomes aware:

- a. that it is in breach of the requirements in respect of financial resources, records, reporting or procedures and controls;
- b. that it will be unable to submit an Annual or Interim Financial Return on the due date.

The notice shall give reasons and shall explain what action is being taken to rectify matters.

7.26 The Licence Holder shall notify the MFSA immediately if:

- a. it is notified that its auditor intends to qualify the audit report;
- b. it becomes aware of actual or intended legal proceedings against it;
- c. it decides to claim on a professional indemnity or other policy relating to its Investment Services business;
- d. the Licence Holder's counter parties in repurchase and reverse repurchase agreements or securities and commodities-lending and securities and commodities-borrowing transactions default on their obligations.

Audit

7.27 The Licence Holder shall appoint an auditor approved by the MFSA. The Licence Holder shall replace its auditor if requested to do so by the MFSA. The MFSA's consent shall be sought prior to the appointment or replacement of an auditor.

The Licence Holder shall make available to its auditor the information and explanations he needs to discharge his responsibilities as an auditor and in order to meet the MFSA's requirements.

7.28 The Licence Holder shall not appoint an individual as an auditor, nor appoint an audit firm where the individual directly responsible for the audit, or his firm is:

- a. a director, partner, qualifying shareholder, officer, representative or employee of the Licence Holder;
- b. a partner of, or in the employment of, any person in (a) above;

- c. a spouse, parent, step-parent, child, step-child or other close relative of any person in (a) above;
- d. a person who is not otherwise independent of the Licence Holder;
- e. a person disqualified by the MFSA from acting as an auditor of a Licence Holder.

For this purpose, an auditor shall not be regarded as an officer or an employee of the Licence Holder solely by reason of being auditor of that Licence Holder.

7.29 The Licence Holder shall obtain from its auditor a signed letter of engagement defining clearly the extent of the auditor's responsibilities and the terms of his appointment. The Licence Holder shall confirm in writing to its auditor its agreement to the terms in the letter of engagement. The auditor shall provide the MFSA with a letter of confirmation in the form set out in Annex II to the Application Form for an Investment Services Licence (whether the Applicant is a Corporate entity or a Sole Trader).

7.30 The letter of engagement shall include terms requiring the auditor:

- a. to provide such information or verification to the MFSA as the MFSA may request;
- b. to afford another auditor all such assistance as he may require;
- c. to vacate his office if he becomes disqualified to act as auditor for any reason;
- d. if he resigns, or is removed or not reappointed, to advise the MFSA of that fact and of the reasons for his ceasing to hold office. The auditor shall also be required to advise the MFSA if there are matters he considers should be brought to the attention of the MFSA;
- e. in accordance with section 18 of the Act, to report immediately to the MFSA any fact or decision of which he becomes aware in his capacity as auditor of the Licence Holder which:
 - i. is likely to lead to a serious qualification or refusal of his audit report on the accounts of the Licence Holder; or
 - ii. constitutes or is likely to constitute a material breach of the legal and regulatory requirements applicable to the Licence Holder in or under the Act;
 - iii. gravely impairs the ability of the Licence Holder to continue as a going concern; or
 - iv. relates to any other matter which has been prescribed.
- f. in accordance with section 18 of the Act, to report to the MFSA any facts or decision as specified in (e) above of any person having close links with the Licence Holder, of which the auditor becomes aware in his capacity as auditor of the Licence Holder or of the

person having close links.

- 7.31** If at any time the Licence Holder fails to have an auditor in office for a period exceeding four weeks the MFSA shall be entitled to appoint a person to fill the vacancy; the fees and charges so incurred being payable by the Licence Holder.
- 7.32** In respect of each annual accounting period, the Licence Holder shall require its auditor to prepare a management letter in accordance with International Standards on Auditing. The auditor must also confirm to the MFSA that the audit has been conducted in accordance with International Standards on Auditing and whether, in the auditor's opinion:
- a. the Annual Financial Return together with the audited annual financial statements are in agreement with the Licence Holder's accounting records;
 - b. the Annual Financial Return has been prepared in accordance with the MFSA's requirements and is consistent with the audited annual financial statements;
 - c. the Licence Holder's Financial Resources have been properly calculated in accordance with the MFSA's requirements and exceed the Licence Holder's Financial Resources Requirement as at the Accounting Reference Date;
 - d. proper accounting records have been kept, and adequate systems for their control have been maintained, as required by the MFSA, during the period covered by the Annual Financial Return;
 - e. i. the Licence Holder has maintained throughout the period covered by the Annual Financial Return, systems adequate to safeguard Customers' Assets and Clients' Money; or
ii. based on review procedures performed, nothing has come to the auditor's attention that causes the auditor to believe that the Licence Holder held Customers' Assets or Clients' Money during the period covered by the Annual Financial Return.
 - f. all information and explanations necessary for the purpose of the audit have been obtained.
- 7.33** Where, in the auditor's opinion, one or more of the requirements have not been met, the auditor shall be required to include in his report a statement specifying the relevant requirements and the respects in which they have not been met. Where the auditor is unable to form an opinion as to whether the requirements have been met, the auditor shall be required to specify the relevant requirements and the reasons why he has been unable to form an opinion.
- 7.34** Licence Holders in receipt of a management letter from their auditor which contains recommendations to remedy any weaknesses identified during the course of the audit, are required to submit to the MFSA by not later than six months from the end of the financial period to which the management letter relates, a statement setting out in detail the manner in which the auditor's recommendations have been/ are being implemented. In the instance where Licence Holders have not taken / are not taking any action in respect of any one or

more recommendations in the auditor's management letter, the reasons are to be included.

- 7.35** Licence Holders are required to include in the Directors' Report (which should form part of the annual report to members of the company), a statement regarding breaches of SLCs or other regulatory requirements which occurred during the reporting period, and which were subject to an administrative penalty or other regulatory sanction.

Where there have been no breaches, it is sufficient merely to say so. However, if there have been breaches, a summary must be provided of the breach(es) committed and regulatory sanction imposed.

Supplementary conditions for Licence Holders subject to the Investor Compensation Scheme Regulations ("the Regulations") issued in terms of the Act.

- 7.36** Licence Holders are required to contribute to the Investor Compensation Scheme ("ICS"), in such manner and within such time limits stipulated in the Regulations, as may be amended from time to time. The Regulations require Licence Holders to make a Fixed and Variable Contribution.

The Variable Contribution must be computed at every accounting reference date of the Licence Holder. Transfers to the Investor Compensation Scheme Reserve which may be required in terms of the Regulations, are to be made by the Licence Holder when drawing up the annual financial statements, and are to be reflected in the Annual Financial Return. The Licence Holder is not required to make any transfers to the Investor Compensation Scheme Reserve in the Interim Financial Returns.

- 7.37** The Licence Holder must insert a suitable note in its annual audited financial statements, outlining the market value of the instruments in which the Investor Compensation Scheme Reserve has been invested, together with a maturity schedule according to the type of instrument, as appropriate.

- 7.38** The process leading to a possible claim for compensation payable by the ICS is triggered by a determination which the MFSA shall make to the ICS in accordance with the terms stipulated in the Regulations. The MFSA may consider the following circumstances in arriving at a decision as to whether to make a determination to the ICS in terms of the Regulations. These should be interpreted as merely indicative, rather than an exhaustive list of such circumstances:

a. a prolonged and recurrent material deficit of the Licence Holder's Financial Resources, where the MFSA is of the opinion that the shareholders are unable to financially support the Licence Holder; or

b. the MFSA is informed of a voluntary winding up of the Licence Holder; or

c. the MFSA has received a complaint from one or more investors to the extent that the Licence Holder was unable to fulfil its obligations arising from claims by such investor(s).

**Financial resources requirements and guidance
on the compilation of the financial return**

Purpose

This Appendix:

[a] details the financial resources requirement;

[b] distinguishes between and explains the meaning of trading and non-trading book business;

[c] defines the various elements which make up the calculation of the Own Funds, each of the risk components, and the fixed overheads requirement; and

[d] explains the manner in which the automated financial return which Licence Holders are required to submit to the Malta Financial Services Authority in terms of the Investment Services Rules, should be completed.

Contents	Page No
The Financial Resources Requirement	2
Trading Book	7
The Automated Financial Return	12
The various elements which make up the calculation of the Own Funds, the Risk Components and the Fixed Overheads Requirement	21
Annex I	48
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1.0 The Financial Resources Requirement

[1.1] In terms of SLC 7.01 of Part C I of the Investment Services Rules, Licence Holders are required at all times to maintain own funds which are equal to or in excess of their capital resources requirement. This shall constitute the Licence Holder's Financial Resources Requirement.

[1.2] The Capital Resources Requirement

The components of the capital resources requirement vary depending on the Category of the Licence Holder. The following tables summarise the components of the capital resources requirement:

[1.2.1] Category 1a, 1b, Category 2, and Category 4

The <u>Capital Resources Requirement</u> shall be the higher of (i) and (ii) below:	
(i)	Initial Capital
(ii)	The higher of the following: (a) the sum of the <u>non-trading book business risk components, the trading book business risk components, the commodities instruments - risk component, the large exposures risk component, and the foreign exchange risk component;</u> (b) the fixed overheads requirement.

[1.2.2] Category 3 - including Operators of MTFs

The <u>Capital Resources Requirement</u> shall be the higher of (i) and (ii) below:	
(i)	Initial Capital
(ii)	the sum of the <u>non-trading book business risk components, the trading book risk components, the commodities instruments - risk component, the large exposures risk component, the foreign exchange risk component, and the operational risk component.</u>

[1.3] General Outline of the Initial Capital and the Risk Components

This section is aimed at explaining the elements which make up the capital resources requirement. Firstly a definition of initial capital is given and this is followed by the minimum capital requirements for the various categories of Licence Holders. A description of each of the risk components is given in section [1.3.2] to [1.3.7]. This is followed by an illustration of all the applicable risk components for Licence Holders.

[1.3.1] Categories of Licence Holders and Initial Capital

For the purpose of these Rules, ‘*initial capital*’ shall be comprised of:

- (a) **equity capital** meaning: share capital subscribed by shareholders or other proprietors, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares; and
- (b) **reserves** meaning: revenue reserves, interim net profits/retained profits for the year, unrealised fair value movements in held for trading financial instruments and other reserves.

Minimum initial capital for the different categories of investment services Licence Holders shall be as follows:

<u>Licence Holder Category</u>		<u>Initial Capital</u> <u>EURO</u>
Category 1 (A)	<p>Licence Holders authorised to provide any Investment Service but not to hold or control Clients’ Money or Customers’ Assets, operate a multilateral trading facility, deal for their own account or underwrite. (This Category does not include managers of Collective Investment Schemes.)</p> <p>Provided that where Category 1 (A) Licence Holders are also registered under the Insurance Mediation Directive, the initial capital requirement shall be reduced to EUR 25,000.</p>	50,000
Category 1 (B)	<p>Licence Holders authorised to deal as agent, arrange deals or provide advice in terms of paragraphs 1 or 2 or 5 of the First Schedule to the Act solely for non-Private Customers but not to hold or control Clients’ Money or Customers’ Assets, deal for their own account or underwrite.</p> <p>Provided that where Category 1 (B) Licence Holders are also registered under the Insurance Mediation Directive, the initial capital requirement shall be EUR 25,000.</p>	<p>25,000 With PII</p> <p>50,000 Without PII</p>
Category 2	Licence Holders authorised to provide any Investment Service and to hold or control Clients’ Money or Customers’ Assets, but not to operate a multilateral trading facility or deal for their own account or underwrite.	125,000

<u>Licence Holder Category</u>		<u>Initial Capital</u> <u>EURO</u>
Category 3	Licence Holders authorised to provide any Investment Service, including operating a multilateral trading facility, to hold and control Clients' Money or Customers' Assets and to deal for their own account or underwrite.	730,000
Category 4	Licence Holders authorised to act as trustees or custodians of Collective Investment Schemes.	125,000

[1.3.2] Risks associated with non-trading book business

This category is made up of the **credit/counterparty risk component**, being the possibility 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 which forms part of the Licence Holder's balance sheet.

[1.3.3] Risks associated with trading book business

This category is made up of **four** risk components:

[i] The position risk component:

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.

[ii] The settlement risk component:

Settlement risk is the risk that the Licence Holder's cash against documents transactions in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

[iii] The counterparty risk component:

Counterparty risk is the amount of capital which the Licence Holder must hold against exposures in financial derivative instruments and credit derivatives.

[iv] 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.

[1.3.4] Commodities Instruments - Risk Component

Commodities Risk is the risk component required to cover the Licence Holder's 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.

[1.3.5] Large Exposures Risk Component

The purpose of the large exposure requirement is to ensure that a firm manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements.

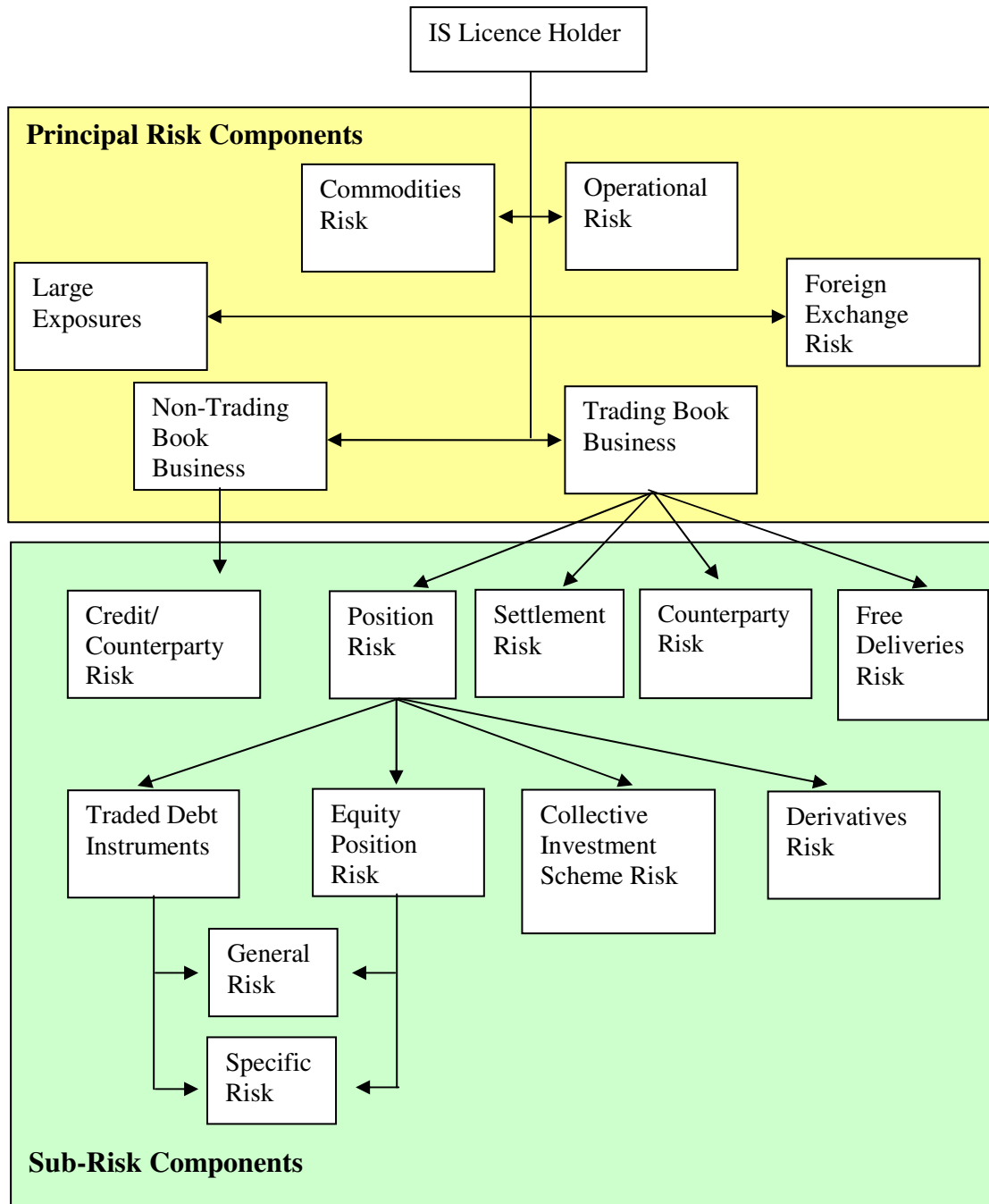
[1.3.6] Foreign Exchange Risk Component

Foreign Exchange Risk is 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.

[1.3.7] Operational Risk Component

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.

[1.4] Table outlining the various risk components



2.0 Trading Book

[2.1] The trading book of a Licence Holder shall consist of all positions in financial instruments held either with trading intent or in order to hedge other elements of the trading book and which are either free of any restrictive covenants on their tradability or are able to be hedged.

Provided that where the following requirements are met, trading book positions may be accounted for as non-trading book positions:

- (a) the trading book business of the Licence Holder does not normally exceed 5 %; and
- (b) their trading-book positions do not normally exceed EURO 15 Million; and
- (c) the trading book business of the Licence Holder never exceeds 6% of total business [being the combined off and on balance sheet business] and total trading book positions never exceed EUR 20 million.

[2.2] The trading book shall also include all positions in derivative financial instruments whether or not these are held for trading.

[2.3] In complying with [2.1] above, a Licence Holder shall abide by the following conditions:

[2.3.1] **Positions held with trading intent**

Positions held with trading intent are those held intentionally for short-term resale and/or with the intention of benefiting from actual or expected short-term price differences between buying and selling prices or from other price or interest rate variations and positions arising from client servicing and market making.

[2.3.2] **Trading intent**

Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the Licence Holder to manage the position or portfolio. These shall include the following:

- (a) The Licence Holder shall have a clear documented trading strategy for the position/instrument or portfolios. Such strategy shall be approved by senior management, and shall include the expected holding horizon;
- (b) The Licence Holder shall have clearly defined policies and procedures for the active management of the position, which shall include the following:
 - (i) positions entered into on a trading desk;
 - (ii) position limits are set and monitored for appropriateness;
 - (iii) dealers have the autonomy to enter into/manage the position within agreed limits and according to the approved strategy;

- (iv) positions are reported to senior management as an integral part of the Licence Holder's risk management process; and
 - (v) positions are actively monitored with reference to market information sources and an assessment made of the marketability or hedge-ability of the positions or its competent risks, including the assessment of, quality and availability of market inputs to the valuation process, level of market turnover, sizes of positions traded in the market; and
- (c) The Licence Holder shall have a clearly defined policy and procedures to monitor the positions against the Licence Holder's trading strategy including the monitoring of turnover and stale positions in the Licence Holder's trading book.

[2.3.3] Systems and controls

Licence Holders shall establish and maintain systems and controls to manage their trading book. Such systems and controls shall be sufficient to provide prudent and reliable valuation estimates and shall include:

- (a) **Documented policies and procedures for the process of valuation**. These should include clearly defined responsibilities of the various areas involved in the determination of the valuations, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month end and ad-hoc verification procedures; and reporting lines for the department accountable for the valuation process that are clear and independent of the front office. The reporting line shall ultimately be to a main board executive director.

- (b) **Prudent valuation methods** as follows:

- (i) Marking to market, comprising as a minimum, the daily valuation of positions at readily available close out prices that are sourced independently. Examples include exchange prices, screen prices, or quotes from several independent reputable brokers;
- (ii) When marking to market, the more prudent side of bid/offer shall be used unless the Licence Holder is a significant market maker in the particular type of financial instrument or commodity in question and it can close out at mid market;
- (iii) Where marking to market is not possible, Licence Holders must mark to model their positions/portfolios before applying trading book capital treatment. Marking to model is defined as any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input;
- (iv) The following requirements must be complied with when marking to model:
 - senior management shall be aware of the elements of the trading book which are subject to mark to model and shall understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business;
 - market inputs shall be sourced, where possible, in line with market prices, and the appropriateness of the market inputs of the particular

position being valued and the parameters of the model shall be assessed on a frequent basis;

- where available, valuation methodologies which are accepted market practice for particular financial instruments shall be used;
- where the model is developed by the Licence Holder itself, it shall be based on appropriate assumptions, which have been assessed and challenged by suitably qualified parties independent of the development process;
- there shall be formal change control procedures in place and a secure copy of the model shall be held and periodically used to check valuations;
- the person/s responsible for risk management shall be aware of the weaknesses of the models used and how best to reflect those in the valuation output; and
- the model shall be subject to periodic review to determine the accuracy of its performance (e.g. assessing the continued appropriateness of assumptions, analysis of profit and loss versus risk factors, and comparison of actual close out values to model outputs).

For the purposes of the fourth bullet point above, the model shall be developed or approved independently of the front office and shall be independently tested, including validation of the mathematics, assumptions and software implementation.

- (v) Independent price verification should be performed in addition to daily marking to market or marking to model. This is the process by which market prices or model inputs are regularly verified for accuracy and independence. While daily marking to market may be performed by dealers, verification of market prices and model inputs should be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/ trading activity, more frequently). Where independent pricing sources are not available or pricing sources are more subjective, prudent measures such as valuation adjustments may be appropriate.

- (c) **Procedures for considering valuation adjustments/reserves** which make provision for (i) unearned credit spreads; (ii) close-out costs; (iii) operational risks; (iv) early termination; (v) investing and funding costs; (vi) future administrative costs and (vii) where relevant, model risk.

(d) Standards for less liquid positions as follows:

- (i) Less liquid positions could arise from both market events and Licence Holder-related situations e.g. concentrated positions and/or stale positions.

- (ii) Licence Holders shall consider several factors when determining whether a valuation reserve is necessary for less liquid positions. These

factors include the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes (number and identity of market makers) and the volatility and average of trading volumes, market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

- (iii) When using third party valuations or marking to model, Licence Holders shall consider whether to apply a valuation adjustment. In addition, Licence Holders shall consider the need for establishing reserves for less liquid positions and on an ongoing basis review their continued suitability.
 - (iv) When valuation adjustments/reserves give rise to material losses in the current financial year, these shall be deducted from the Licence Holder's income statement.
 - (v) Other profits/losses originating from valuation adjustments/reserves shall be included in the calculation of 'net trading book profits' and are to be added to/deducted from the Total Own Funds eligible to cover the risk components according to such provisions.
 - (vi) Valuation adjustments/reserves which exceed those made under the accounting framework to which the Licence Holder is subject shall be treated in accordance with either point (iv) if they give rise to material losses, or otherwise in accordance with point (v) above.
- (e) **Policies and procedures covering inclusion in the trading book** as follows:
- (i) Licence Holders shall have clearly defined policies and procedures for determining which position to include in the trading book for the purposes of calculating their capital requirement, consistent with the criteria set out in points [2.3.1] and [2.3.2] above and taking into account the Licence Holder's risk management capabilities and practices. Compliance with these policies and procedures shall be fully documented and for those Licence Holder having an internal audit function.
 - (ii) Licence Holders shall have clearly defined policies and procedures for overall management of the trading book. As a minimum these policies and procedures shall address:
 - the activities the Licence Holder considers to be trading and as constituting part of the trading book for capital requirement purposes;
 - the extent to which a position can be marked-to-market daily by reference to an active, liquid two-way market;
 - for positions that are marked-to-model, the extent to which the Licence Holder can:
 - (i) identify all material risks of the position;
 - (ii) hedge all material risks of the position with instruments for

which an active, liquid two-way market exists; and **(iii)** derive reliable estimates for the key assumptions and parameters used in the model;

- the extent to which the Licence Holder can, and is required to, generate valuations for the position that can be validated externally in a consistent manner;
- the extent to which legal restrictions or other operational requirements would impede the Licence Holder's ability to effect a liquidation or hedge of the position in the short term;
- the extent to which the Licence Holder can, and is required to, actively risk manage the position within its trading operation; and
- the extent to which the Licence Holder may transfer risk or positions between the non-trading and trading books and the criteria for such transfers.

[2.3.4] Internal Hedging

When including internal hedging in their trading book, Licence Holders shall comply with the following:

- (a)** An internal hedge is a position that materially or completely offsets the component risk element of a non-trading book position or a set of positions. Positions arising from internal hedges are eligible for trading book capital treatment, provided that they are held with trading intent and that the general criteria on trading intent and prudent valuation specified in points [2.3.1] and [2.3.2] are met. In particular:
- internal hedges shall not be primarily intended to avoid or reduce capital requirements;
 - internal hedges shall be properly documented and subject to particular internal approval and audit procedures
 - the internal transaction shall be dealt with at market conditions;
 - the bulk of the market risk that is generated by the internal hedge shall be dynamically managed in the trading book within the authorised limits; and
 - internal transactions shall be carefully monitored;
 - monitoring must be ensured by adequate procedures.
- (b)** The treatment referred to in point **(a)** applies without prejudice to the capital requirements applicable to the 'non-trading book leg' of the internal hedge.

3.0 The Automated Financial Return

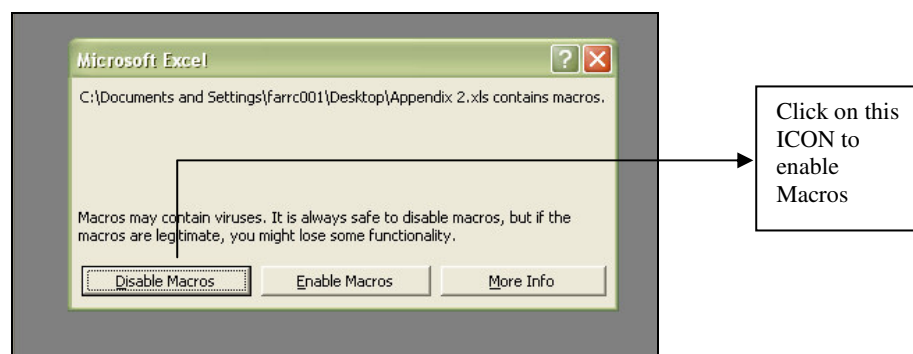
[3.0] This section of the Appendix provides detailed instructions on how Licence Holders are to use the Automated Financial Return. It then provides an explanation of how Licence Holders are to complete a number of worksheets in the Return, namely: [i] Cover Sheet, [ii] the Input Sheet (Sheet 1), [iii] the Income Statement (Sheet 2), [iv] the Balance Sheet (Sheet 3), [v] Financial Details (Sheet 16), [vi] Representations (Sheet 17), [vii] Certificate of Compliance (Sheet 18), [viii] Statistics (Sheet 19) and [ix] Validation Sheet.

Detailed explanations of the: [i] Own Funds (Sheet 4), [ii] the risk components (Sheets 5 – 13), [iii] the Fixed Overheads Requirement (Sheet 14) and [iv] the Capital Resources Requirement (Sheet 15) are provided in section 4.0 of this Appendix.

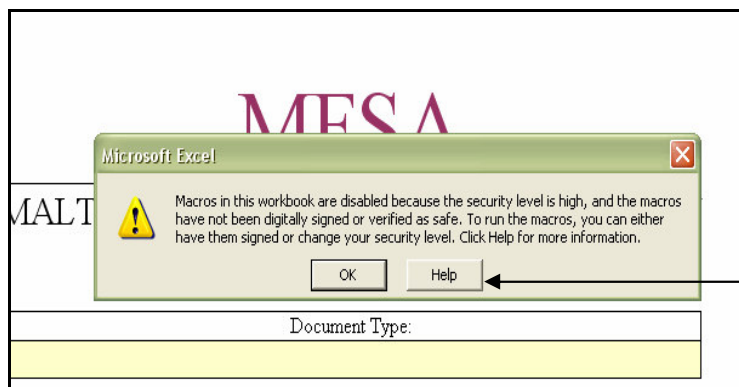
[3.1] Instructions for using the Automated Financial Return

- (a) This section of the Appendix provides guidance for Investment Services Licence Holders when compiling the automated Interim Financial Return (“IFR”), the automated Annual Financial Return (“AFR”) and the automated Annual Audited Financial Return (“AAFR”). Unless otherwise specified, the term “Return” and the Rules of the Appendix refer to the IFR, AFR and AAFR.
- (b) The Return is compiled via an Ms Excel file titled, “APPENDIX 2.XLS”. This file has been optimised for use on Microsoft Excel 2002. Some functions may not work if converted for use with other software or previous versions of Excel. These Excel files are to be retained as Master Copies.

When opening the Excel Spreadsheet named “APPENDIX 2.XLS” a window will open up which will give the option to enable the macros. Click on the button “Enable Macros” prior to proceeding with the compilation of the Return.



If a further pop-up window appears on screen, as shown in the figure below, kindly amend the program’s settings as described on the next page..



If this note pops up, then amend the settings of your computer as follows: Click on “Tools”, “Options”, “Security”, “Macro Security”, “Medium” or “Low”.

- (c) Each Return consists of **nineteen** worksheets. To select a worksheet, go to the “CONTENTS” sheet and click on the button next to the required sheet.
- (d) The worksheets are password protected. With the exception of cells highlighted in yellow, all cells in this program are locked and only these cells allow the inputting, deleting and amending of values.
- (e) In instances where the cells are linked, only the values need to be inputted once.
- (f) Subtotals are calculated automatically.
- (g) A number of worksheets require manual intervention by being prompted to execute a function or to input a value. Any computer prompted instructions are to be followed carefully.
- (h) Licence Holders are to provide additional details where required. This is required at the bottom of “SHEETS 2 and 3”. It is preferable that entries should not exceed the space provided for this purpose.
- (i) A number of worksheets require the Licence Holder to provide supporting documentary evidence of how a particular figure was calculated. Licence Holders are to attach such documents as annexes to the Return and clear reference to the relevant worksheet should be included.
- (j) The compilation of the automated Returns should start from the first worksheet (that is, the “COVER SHEET”). Details should be inserted (as and where appropriate) starting from the top and moving to the end of each worksheet.
- (k) The following is an outline of all the applicable sheets together with an indication of which sheets require manual input and those which are fully automated:

<u>Sheet</u>	<u>Sheet title</u>	<u>Action to be taken</u>
Cover Sheet		Manual Input [mandatory]
Contents Sheet	Contents	N/A
Sheet 1	Input Sheet	Manual Input [mandatory]
Sheet 2	Income Statement	Manual Input [where applicable]
Sheet 3	Balance Sheet	Manual Input [where applicable]
Sheet 4	Own Funds	Manual Input [where applicable]
Sheet 5	Credit/Counterparty Risk	Fully Automated
Sheet 6	Position Risk Component Traded Debt Instruments [Specific Risk Component]	Fully Automated
Sheet 7	Position Risk Component Traded Debt Instruments [General Risk Component]	Fully Automated
Sheet 8	Position Risk Component Equity	Fully Automated

<u>Sheet</u>	<u>Sheet title</u>	<u>Action to be taken</u>
Sheet 9	Position Risk Component Collective Investment Schemes	Fully Automated
Sheet 10	Settlement Risk Component	Fully Automated
Sheet 11	Free Deliveries	Fully Automated
Sheet 12	Large Exposures Risk Component	Manual Input [where applicable]
Sheet 13	Foreign Exchange Risk Component	Manual Input [where applicable]
Sheet 14	Fixed Overheads Requirement	Fully Automated
Sheet 15	Capital Resources Requirement	Manual Input [where applicable]
Sheet 16	Financial Details	Manual Input [mandatory]
Sheet 17	Representations	Manual Input [mandatory]
Sheet 18	Certificate of Compliance	Manual Input [mandatory]
Sheet 19	Statistics	Manual Input [mandatory]
Validation Sheet		Fully Automated

- (l) For ease of reference, the sheets which require manual input have been marked in **blue** in the “CONTENTS” Sheet.
- (m) Users should not key in “0” or “-” whenever a value is nil but should leave the cell empty.
- (n) **Only the worksheets which are marked in red in the “CONTENTS” sheet must be printed.**
- (o) **Returns should be submitted by their due date in both hardcopy (signed) and electronic format (by diskette, compact disc or e-mail). Please note that the submission of Returns by e-mail is at the Licence Holder’s own discretion and risk (since communications by e-mail may not be secure).**

[3.2] Cover Sheet

- (a) All cells in items 1 to 8 which are highlighted in yellow are to be completed.
- (b) Item 1: Select document type – either Annual or Interim Financial Return – from the drop down list depending on the period for which the Return is being compiled.

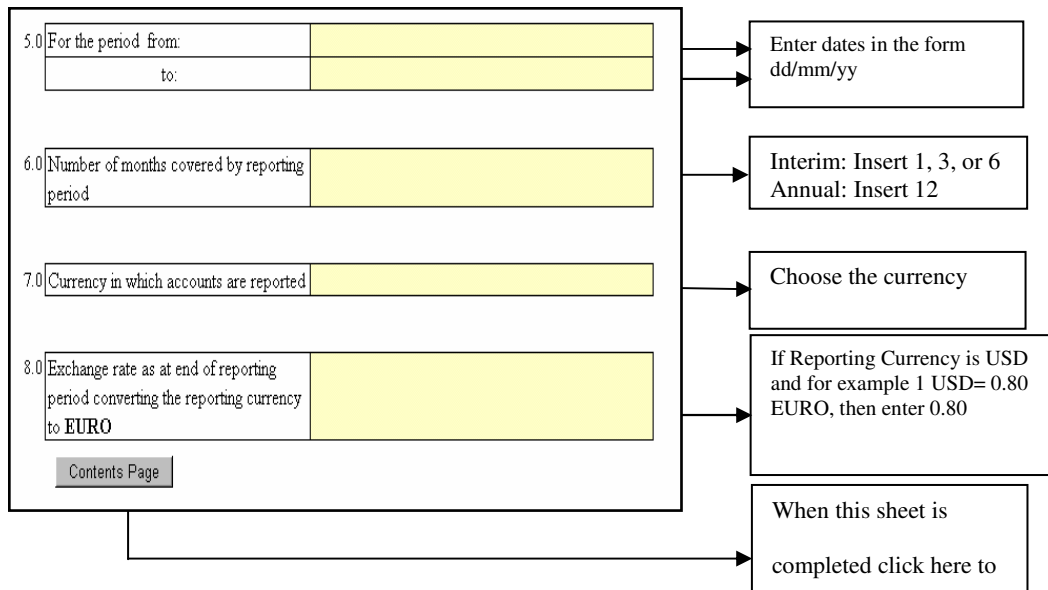
MFSA
MALTA FINANCIAL SERVICES AUTHORITY

1. Document Type:

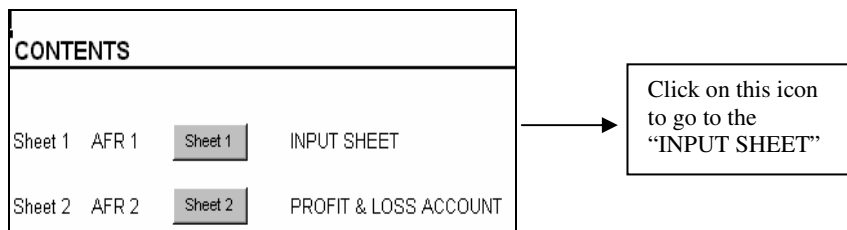
2. Name of Licence Holder

Select Document type – either Interim Financial Return or Annual Financial Return

- (c) Returns are to be prepared in the currency in which the Audited Annual Financial Statements are compiled. The Reporting Currency of the accounts should be inserted in ISO Code.
- (d) Irrespective of the Reporting Currency, the relevant Middle Exchange Rate converting EUR to the Reporting Currency is to be inserted in Item 8.
- (e) Upon satisfactory completion of items 1 – 8, click on the button “Contents Page” at the end of this sheet to go to the “Contents Sheet”.



[3.3] Input Sheet – Sheet 1



(a) Click on the button "SHEET 1" in the 'Contents Sheet' to go to the "INPUT SHEET".

(b) The Input Sheet has a similar structure to a Trial Balance. All amounts on the **credit** (mainly items of **income and liabilities**) are to have a negative figure, by inserting a '-' sign before the figure. On the other hand, all the amounts on the **debit** (mainly **assets and expenses**) should be indicated as positive by inserting the '+' sign before the figure. If a negative amount is filled in a cell representing an asset, the program will prompt the Licence Holder to insert a positive amount. In general, the Licence Holder will not be allowed to insert a negative amount in a cell representing an asset or an expense. Similarly such Licence Holder will not be allowed to insert a positive amount in a cell representing an item of income or a liability. For convenience, some cells have an automated pop-up window explaining what must be inserted.

(c) The "INPUT SHEET" is mainly divided into six sections as follows:

- i. Income
- ii. Expenses
- iii. Assets
- iv. Liabilities
- v. Capital & Reserves
- vi. Other

- (d) Under the “**Income and Expenses**” sections, one must include the revenue/ expenses earned/ incurred by the Licence Holder during the reporting period.

[N.B.] Besides providing for taxation in the Annual Income statement included in the AFR, Licence Holders are also required to provide for taxation in the Interim (monthly, quarterly or half-yearly – as applicable) Income statement in the IFR.

- (e) *Allowable Commissions and Fees*, Item 2 (a) in the “Revenue” section relates to commissions and fees payable, provided they are directly attributable to commissions and fees receivable which are included in total revenue.
- (f) For the purpose of the IFRS prudential reporting framework report [i] Unrealised fair value movements on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account, Item 2 (q) [ii] fair value movements on ‘available for sale’ financial instruments as per IAS 39, Item 2 (q), and [iii] revaluations on property as per IAS 40, Item 2 (r).
- (g) *Exceptional Expenditure, Item 2 (c) (i) in the “Expenditure” section* are items of expenditure for which the MFSA’s no-objection should be sought prior to their inclusion in the Return.
- (h) Under the “Assets” section, financial instruments, both long and short positions, held on the Licence Holder’s (item 3 (d)) balance sheet are to be categorised under one of the available headings. The long or short position in a particular investment is the net of any long or short positions held in that same investment. The Licence Holder must include both the balance sheet value and the market value of these financial instruments. Where financial instruments are held at fair values, the Licence Holder must input the market value under both cells. It is important that financial instruments are inserted under the appropriate heading.
- (i) *Collective investment schemes*, Item 3 (e) (iii), are any amounts receivable by the Licence Holder from transactions in collective investment schemes.
- (j) *Group creditors - due within 1 year*, Item 4 (d) and *Group creditors - due after more than 1 year*, Item 4.0 (h). These represent amounts receivable from group companies and/ or connected persons. The definition of “Group” to be considered is that defined in the Companies Act, 1995 and “connected counterparty” as defined in Section 4.2.4 [A] (iii).
- (k) The Licence Holder must also indicate under Item 6 (a) whether it has any assets or liabilities denominated in a Foreign Currency. If the answer is “YES” the Licence Holder must compile Sheet 13 which deals with Foreign Exchange Risk adjustments.
- (l) *Secured Liabilities*, Item 6(b). Under item [i], the Licence Holder must include the total secured liabilities which are due within 1 year. On the other hand, under item [ii] the Licence Holder must insert that part of the amount inserted in [i] which is secured by a charge on land and buildings. Under item [iii], the Licence Holder must include the total secured liabilities which are due after more than 1 year. Similarly, under item [iv] the Licence Holder must insert that part of the amount inserted in [iii] which is secured by a charge on land and buildings.
- (m) Once the relevant parts of Sections 1 – 6 have been completed click on the button “**Print Set-up**”. Automatically, all those cells which have been left empty will be hidden. After printing this sheet, the user may click on the button “**Show all**” and all the hidden cells will re-appear. Click on the button “Return to Contents” to return to

the contents page.

[3.4] Income Statement – Sheet 2

- (a) This sheet is fully automated except for Items 8.0 and 19.0.
- (b) The space provided in Item 8.0 (“*Details of ‘Other ISA related revenue’ and/or Any other details or comments*”) is to be used to explain Item 5.0 (“*Other ISA related revenue*”).
- (c) The space provided in Item 19.0 (“*Details of Exceptional items of expenditure allowed by MFSA, other variable expenditure and other fixed expenditure*”) should provide explanations to Item 10.0 (a) (“*Exceptional Items of expenditure allowed by MFSA*”), item 11.0 (j) (“*Other Variable Expenditure*”) and item 11.0 (k) (“*Other Fixed Expenditure*”).

[3.5] Balance Sheet – Sheet 3

- a. This sheet is fully automated except for Item 12.0.
- b. The space provided in Item 12.0 (“*Details of ‘Amounts due to/ from other connected persons’ and/or ‘Amounts due to/ from Group Companies’ and/or Any other details or comments*”) should include explanations to the following Items:
 - i. Item 3.0(c) (“*Amounts due from Group Companies*”)
 - ii. Item 3.0(d) (“*Amounts due from other connected persons*”)
 - iii. Item 4.0(d) (“*Amounts due to Group Companies – within 1 year*”)
 - iv. Item 4.0(e) (“*Amounts due to other connected persons – within 1 year*”)
 - v. Item 7.0(b) (“*Amounts due to Group Companies – after more than 1 year*”)
 - vi. Item 7.0(c) (“*Amounts due to other connected persons – after more than 1 year*”)

[3.6] Sheet 16 – Financial Details

- a. Where applicable, all the cells marked in yellow are to be inputted.
- b. Some cells enable the user to select a reply from a drop down menu.
- c. The Licence Holder should only mark as “Yes” questions 1, 4 and 6 of this Sheet if the particular investment services activities are allowed by the licence granted in terms of the Investment Services Act, 1994.
- d. Where the Return is being compiled as an Audited Annual Financial Return and where applicable, the total amount in the reporting currency of the assets held under nominee and the number of clients (beneficial owners) is to be inputted in Item 3.
- e. The Licence Holder may add further details/comments in item 7 of this Sheet.

[3.7] Sheet 17 – Representations

- a. Items 1 – 4 of this sheet must be filled and signed by the Licence Holder.
- b. In cases where the Licence Holder is a sole trader, only the owner is required to sign the Return. Otherwise the Return is to be signed by two Directors or other authorised signatories. When the Return is signed by the latter, the Licence Holder should provide a certified true copy of the Board of Directors’ Resolution authorising the

individual to sign the Return on behalf of the Directors.

- c. Where the Return is being compiled as an Audited Annual Financial Return, items 5 and 6 of the Return are to be completed. Furthermore, it must also be signed by the auditor of the Licence Holder.

[3.8] Sheet 18 – Certificate of Compliance

- a. This sheet must be filled in with every Return.
- b. Any breaches to the Investment Services Act, 1994 and/or to the standard licence conditions, are to be filled in the space provided,
- c. The Licence Holder should also indicate whether any complaints were received during the reporting period and if in the affirmative the Licence Holder is to include: **[i]** the number of complaints received is to be included and **[ii]** those which are still pending at the end of the reporting period.

[3.9] Sheet 19 – Statistics

- a. This sheet must be filled in with every Return.
- b. The Statistics sheet shall be compiled in accordance with the Guidance Note issued on the 1st November, 2005 titled: “Statistical Requirements for Investment Services Licence Holders.

[3.10] Validation Sheet

Prior to submitting the Return to the MFSA, the Licence Holder must ensure that all Validations are marked “OK”. Where the Validation is marked “ERROR”, the Licence Holder should check and correct the relevant sheet accordingly.

4.0 The various elements which make up the calculation of the Own Funds, the Risk Components and the Fixed Overheads Requirement

[4.1] Own Funds

Own Funds means the sum of tier one capital, tier two capital and tier three capital.

[4.1.1] **Tier one capital** is made up of items of a capital nature which: (a) are permanent; (b) are able to absorb losses; (c) rank for repayment upon winding up after all other debts and liabilities; and (d) do not yield a fixed return to their investors but provide dividends/ interest at the discretion of the board of directors of the Licence Holder.

Tier one capital, being the summation of points (A) + (B) – (C) - (D) below:

(A) **Core Tier One Capital:**

[i] **Ordinary share capital:**

The nominal paid-up value of the share capital. The unpaid element of partly paid-up shares or authorized share capital is to be excluded.

[ii] **Share premium account:**

Any amount received in excess of the nominal value of any issued ordinary shares.

[iii] **Revenue reserves:**

Revenue Reserves as at the beginning of the reporting period.

[iv] **Interim net profits/retained profits for the year:**

Profits for the reporting period.

[v] **Other reserves**

(B) **Non - Core Tier One Capital:**

[i] **Perpetual non-cumulative preference shares:**

Perpetual (non-redeemable) non-cumulative preference shares (if not redeemable within 5 years), which have been issued and paid up.

[ii] **Minority Interests [applicable for the scope of consolidation]**

That portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries,

by the parent.

(C) **Deductions from Tier One Capital:**

[i] **Investments in own shares:**

Own Shares held at book value.

[ii] **Formation Expenses:**

Expenses incurred at formation stage which have been capitalised.

[iii] **Goodwill:**

Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

[iv] **Other Intangible assets:**

Any other indefinable non-monetary assets without physical substance.

[v] **Material current year losses/retained losses for the year:**

Losses for the reporting period.

(D) **Additional deductions from Tier One Capital [IFRS Prudential Filters]:**

For the purpose of prudential filters for regulatory capital, any unrealised losses on Items [i] to [iii] below are to be fully deducted.

[i] **Deduct 100% of unrealised losses on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - [in accordance with IAS 39]**

[ii] **Deductions in relation to fair value movements on 'available for sale' financial instruments as per IAS 39**

[iii] **Unrealised losses on revaluation of property**

Unrealised losses on revaluation of property as per IAS 40.

[4.1.2] **Tier two capital** consists of instruments that combine the features of debt and equity wherein they are structured like debt but exhibit some of the loss absorption and funding flexibility forms of equity.

Tier two capital, being the summation of points (A) + (B) + (C) – (D) below:

(A) **Upper Tier Two Capital:**

[i] **Revaluation Reserves:**

Reserves arising from the revaluation of tangible fixed assets and financial fixed assets.

[ii] Perpetual Securities:

Perpetual securities are securities including cumulative preference shares which fulfil the following conditions: **(a)** they may not be reimbursed on the bearer's initiative or without the prior agreement of the MFSA; **(b)** the debt agreement must provide for the Licence Holder to have the option of deferring the payment of interest on the debt; **(c)** the lender's claims on the reporting Licence Holder must be wholly subordinated to those of all non-subordinated creditors; **(d)** the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the reporting Licence Holder in a position to continue trading; **(e)** only full paid-up amounts are to be considered.

(B) Lower Tier Two Capital:

[i] Perpetual non-cumulative preference shares:

Perpetual (non-redeemable) non-cumulative preference shares (if not redeemable within 5 years), which have been issued and paid up.

[ii] Subordinated Loan Capital

Subordinated loans which have been approved by the MFSA. The subordinated loans must be approved by the MFSA and must be in form set out in Annex I.

The admissible amount must not be greater than **150%** of Total Tier One Capital after deductions.

[iii] Bank and/or other third party guarantees

Bank or third party guarantees approved by the MFSA. The guarantee must be in form set out in Annex II or III.

[iv] Internal ratings based approach [IRB] to risk weight exposure:

Applicable only for Licence Holders availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in section 4.2.1.1 [A].

(C) Additions Prudential Filters

[i] Unrealised profits on financial assets which are designated at inception as assets to be maintained at fair value through the profit and loss account - [in accordance with IAS 39]

This calculation adds back 65% of additions to fair value movements on assets to be maintained at fair value through the profit and loss account.

[ii] Additions in relation to fair value movements on 'available for sale' financial instruments as per IAS 39

This calculation adds back 65% of additions to fair value movements on

available for sales financial assets.

[iii] Unrealised gains on revaluation of property

This calculation adds back 65% of the Unrealised losses on revaluation of property done in terms of IAS 40.

(D) Deductions from Tier Two Capital

[i] Material Holdings in credit and financial institutions

These being holdings by the Licence Holder of more than 10% of the capital of other credit or financial institution as defined in the European Directive 2006/48 EC

[ii] Expected losses from risk weighted exposure amount using the Internal Ratings Based approach to credit risk

Applicable only for Licence Holders availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in section 4.2.1.1 [A].

[iii] IRB value adjustments

Applicable only for Licence Holders availing of the internal ratings based approaches, in the calculation of credit risk. These approaches are explained in section 4.2.1.1 [A].

[iv] Additional deductions

Where the Licence Holder forms part of a financial conglomerate, participations and/ or other instruments held in insurance schemes, reinsurance schemes and insurance holding companies are to be deducted.

[v] Additional capital requirement

Additional capital requirement - in the case where half of the total of items (i) to (iv) above exceed **total tier two capital** (Upper Tier Two Capital + Lower Tier Two Capital), the amount by which tier two capital is exceeded should be taken as a deduction from own funds.

[4.1.3] Tier three capital is composed of Interim Trading Book Profits and Losses. Any profits or losses which the Licence Holder makes with respect to trading book business which includes any foreseeable charges and dividends and which has not been included in the Income Statement [point 4.1.1 A [iii]] is to be included in this item.

[4.1.4] Restrictions on Own Funds:

(a) Non-core tier one capital is to be **less than 50%** of total tier one capital after deductions;

(b) Total tier two capital **must at all times be less** than total tier one capital after deductions;

- (c) Lower tier two capital **must at all times be less than 50%** of total tier one capital after deductions; and
- (d) Total tier two capital after deductions and tier three capital **must at all times be less than 200%** of total tier one capital after deductions

Licence Holders must ensure that the above conditions are met at all times. Should the Licence Holder be in breach of any of the above conditions, the MFSA is to be immediately notified.

- [4.1.5] **The Return:** Sheet 4 – [Own Funds] of the Return, which calculates the Licence Holder's own funds is fully automated and does not require any form of manual intervention.

A pop-up window will appear on screen where any of the restrictions listed in section [4.1.4] have been exceeded. An additional warning will appear on the lower part of the Return. The Licence Holder should inform the MFSA of the action to be taken to reduce this exposure.

[4.2] **Risk Components**

- [4.2.1] **Non Trading Book Business Risk Component:**

This category is made up of the credit/counterparty risk component.

- [4.2.1.1] **Credit/Counterparty Risk Component**

Being the possibility 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] **Measuring the Credit/Counterparty Risk**

The credit/ counterparty risk can be measured through any one of the following three methods: [i] the Standardised Approach, [ii] the Foundation Internal Ratings Based Approach [**FIRB**] or the [iii] the Advanced Internal Ratings Based Approach [**AIRB**].

The **Standardised Approach** calculates the credit risk component by applying a broad category of risk weights to **non-trading book business asset exposures**.

N.B. These Rules and the Return cater for the Standardised Approach. The FIRB and the AIRB approaches are based on the Licence Holder's

assessments of the risks to which it is exposed. It is strongly recommended that MFSA's guidance is sought prior to adopting these alternative methods, which methods are to be approved by the MFSA.

[B] Credit/ Counterparty Risk applying the Standardised Approach

The computation of the credit/counterparty risk component using the standardised approach is calculated as follows:

- [i]** identify the **exposure value** of the asset item – i.e. the balance sheet value of that particular asset;
- [ii]** assign each exposure to one of the exposure classes defined in [C] below;
- [iii]** calculate the **risk weighted exposure amounts** by multiplying the **exposure value** by an **applicable risk weight**;
- [iv]** add the total risk weighted exposure amounts; and
- [v]** **the credit/counterparty risk capital component is 8% of the total risk weighted exposure amounts.**

[C] Exposure classes

The **non-trading book business asset exposures** of Licence Holders are to be categorised within one of the **8** exposure classes which are explained further on in this section.

A number of these **Exposure Classes** apply the **Credit Quality Steps Approach** ['CQSA']. In terms of **CQSA**, the individual risk weighting of non-trading book asset exposures is to be assigned a risk weighting depending on their credit quality assessment rating.

Steps to use the CQSA:

- [i]** Check whether the relevant **non-trading book business asset exposure** is rated by one of the following rating agencies: **Fitch Rating, Moody's, and Standard and Poor's**;
- [ii]** Obtain from the rating agency the rating of the relevant **non-trading book business asset exposure**;
- [iii]** Apply the following mapping table to categorise the **non-trading book business asset exposure** in one of the **credit quality steps**:

Credit Quality Step	Fitch's assessment	Moody's assessment	S&P assessment
1	AAA to AA-	Aaa to Aa3	AAA to AA-
2	A+ to A-	A1 to A3	A+ to A-
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
5	B+ to B-	B1 to B3	B+ to B-
6	CCC+ and below	Caal and below	CCC+ and below

[iv] the risk weighting assigned to the **non-trading book business asset exposure** will vary depending on the type of exposure class and the credit quality step assigned.

Exposure – Class 1

Tangible Assets – [such as land, building, office furniture]

Risk Weighting

The risk weight to be applied is **100%**.

Exposure – Class 2

Claims or contingent claims on central governments or centralbanks – [such as Government Bonds or T-bills]

Risk Weighting

(a) Exposures to EEA States

Exposures to **EEA states'** central governments and central banks denominated in the national currency of the borrower should be assigned a **0%** risk weight.

(b) Applying the CQSA

Use the **CQSA** where the **non-trading book business asset exposure** is rated by one of the rating agencies mentioned in C [iii] above. The following risk

weightings will apply depending on the credit quality step category within which the relevant **non-trading book business asset exposure falls.**

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	50	100	100	100	150

(c) Other Class 2 exposures

Other exposures are to be allocated a risk weight of **100%**.

Exposure – Class 3

Amounts receivable from EEA Financial Services Licensed Entities [such as accruals and debt securities]

Risk Weighting

(a) Exposures to debt securities redeemable after three months

Applying the CQSA: Use the CQSA where the **exposure to debt securities issued by EEA Financial Services Licensed Entities** is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant **debt exposure falls.**

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	50	50	100	100	150

Unrated exposures which fall within this category are to be allocated a risk weight of **50%**.

(b) Exposures to debt securities redeemable before three months

Applying the CQSA: Use the CQSA where the **exposure to debt securities issued by EEA Financial Services Licensed Entities** is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant **debt exposure falls.**

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	20	20	50	50	150

Unrated exposures which fall within this category are to be allocated a risk weight of **20%**.

(c) Other Class 3 exposures

Amounts which fall within this category and are due within three months are to be assigned a risk weight of **20%**.

Other amounts due should be assigned a risk weight of **50%**.

Exposure – Class 4

Amounts receivable from Corporates/ other Entities other than EEA Financial Services Licensed Entities

Risk Weighting

(a) Applying the CQSA:

Use the CQSA where the **exposure to debt securities issued by corporates other than EEA Financial Services Licensed Entities** is rated by one of the rating agencies mentioned above. The following risk weightings will apply depending on the credit quality step category within which the relevant **debt exposure falls**.

Credit Quality step	1	2	3	4	5	6
Risk weight - %	20	50	100	100	150	150

(b) Other Class 4 exposures

Other exposures including which within this category are to be allocated a risk weight of **100%**.

Exposure – Class 5

Investments in collective investment schemes

(a) High Risk Collective Investment Schemes:

Investments in units of Collective Investment Schemes which have the majority of their portfolio invested in high risk instruments such as derivatives should be allocated a risk weight of **150%**.

(b) Other Collective Investment Schemes:

Investments in other collective investment schemes should be allocated a risk weight of **100%**.

Exposure – Class 6

Shares

Risk Weighting

(a) Shares traded on a EU Regulated Market or the Regulated Market of a developed financial centre

The risk weight to be applied is **100%**.

(b) Other Shares [including investments in Venture Capital Firms private equity investments]

The risk weight to be applied is **150%**.

(c) Investments in connected companies.

The risk weight to be applied is **100%**.

Exposure – Class 7

Amounts receivable from Government Bodies and Local Authorities

Risk Weighting

Amounts due within three months are to be assigned a risk weight of **20%**. Other amounts due should be assigned a risk weight of **50%**.

Exposure – Class 8

Other Balance Sheet Items

[Prepayments and accrued income; amounts due from group or connected companies; amounts due from collective investment schemes; and other debtors]

Risk Weighting

The risk weight to be applied is **100%**.

[D] Credit/Counterparty Risk - Steps to be followed in the Return

In the Input Sheet of the Return:

[i] identify those assets which qualify as non-trading book business asset exposure;

[ii] categorise the non-trading book business asset exposure under one of the headings in [C] above;

[iii] input a description of the relevant non-trading book business asset exposure;

[iv] input the '*balance sheet value*' and the '*market value*' of the non-trading book business asset exposure in the adjacent columns

[v] qualify the asset as a non-trading book business asset exposure by choosing letter 'N' from the drop down list which is available in the column titled '*Held with trading intent?*';

[vi] where the risk weighting of the non-trading book business asset exposure is determined through the CQSA, depending on the category of asset, choose the applicable option from the drop down list which is available in the column titled '*Credit Quality Assessment*';

[v] the return will automatically compute the credit risk component in sheet 5.

[4.2.2] **Trading Book Business Risk Components:**

This category is made up of four risk components: (i) the position risk component; (ii) the settlement risk component; (iii) the counterparty risk component; and (iv) free deliveries.

[4.2.2.1] **Position Risk**

The risk of losses in on and off balance sheet investments in financial instruments, which qualify as trading book business, arising from the movement in market prices. For the purpose of the calculation of position risk, financial instruments are categorised under one of the following titles: [i] Traded Debt Instruments; [ii] Traded Equities; [iii] Collective Investment Schemes; and [iv] Derivatives.

N.B. These Rules and the Return provide for the calculation of the position risk component of all types of financial instruments except for derivatives. As it is generally the exception that Licence Holders invest in derivatives, MFSA has taken the approach that the calculation of the risk related to investments in such assets may be catered for on a case by case basis. Licence Holders who invest in derivatives should contact the MFSA for guidance as to how the derivatives related position risk component should be catered for in their Return.

[A] **Measuring the Position Risk Component**

The methodology for measuring the position risk component varies depending on the type of financial instrument. The following explains the manner in which the position risk component is calculated.

[B] **Traded Debt Instruments / Traded Equities**

The calculation of the position risk component for **Traded Debt Instruments**, and **Traded Equity** is based on two factors being:

[i] the *specific risk factor* which is the risk of a price change in the instruments due to risks inherent to its Issuer; and

[ii] the *general risk factor* being the risk of a price change in the instruments due to a change in the level of interest rates in the case of a traded debt instrument or a broad equity market movement unrelated to specific attributes of individual securities in the case of equity.

[B.1] Traded Debt Instruments

[i] Specific Risk

The **specific risk factor of the position risk component of a traded debt instrument** is equivalent to the market value of the debt instrument multiplied by the applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

- (a) the classification of the debt instrument;
- (b) the rating of the debt instrument (if any) – for an explanation of how to establish the rating of a Debt Instrument, please refer to the explanation of the CQSA in point [C] of section 4.2.1; and
- (c) the number of months to maturity.

In order to calculate the specific risk for the position risk component of traded debt instruments, the following classifications/position risk weightings apply:

<u>Traded Debt Instrument Classifications</u>	<u>Rating Credit Quality Steps</u>	<u>Number of months to maturity</u>	<u>Risk Weights</u>
CATEGORY 1 Debt instruments issued by the central governments or <i>centralbanks</i> - same as credit risk - class 2 exposure however, falling within the definition of trading book business;	CQS 1 or 0% Risk Weight	Any	0%
	CQS 2 or 3	0 - 6 Months	0.25%
		6 – 24 Months	1%
		Over 24 Months	1.6%
	CQS 4 or 5	Any	8%
CQS 4 or 5	Any	12%	

<u>Traded Debt Instrument Classifications</u>	<u>Rating Credit Quality Steps</u>	<u>Number of months to maturity</u>	<u>Risk Weights</u>
CATEGORY 2		0 - 6 Months	0.25%
Debt instruments issued by EEA Financial Services Licensed Entities - same as credit risk – class 3 exposure however, falling within the definition of trading book business	CQS 1 or 2	6 – 24 Months	1%
		Over 24 Months	1.6%
AND			
CATEGORY 3	CQS 3 or 4	Any	8%
Other debt instruments being – Debt instruments issued by Corporates /other entities other than EEA Financial Services Licensed Entities– class 4 exposure however, falling within the definition of trading book business	CQS 5 or 6	Any	12%

[ii] **General Risk**

The **general risk factor of the position risk component of a traded debt instrument** is equivalent to the market value of the debt instrument multiplied by the applicable position risk weighting, which weighting depends on (a) the coupon rate; (b) the number of months to maturity; and (c) the zone within which the said debt instrument falls. Traded debt instruments are categorised into three zones depending on the time to maturity of each particular instrument. The scope of this categorisation is to net any opposite positions (long and short) within the same zone.

The table in the following page outlines the applicable general position risk weighting of debt instruments which qualify as trading book business:

Zone	Maturity Band		Weighting
	Coupon which is less than 3%	Coupon which is 3% or more	
One	0 to 1 month	0 to 1 month	0.00%
	Over 1 month and less than or equal to 3 months	Over 1 month and less than or equal to 3 months	0.20%
	Over 3 months and less than or equal to 6 months	Over 3 months and less than or equal to 6 months	0.40%
	Over 6 months but less than or equal to 12 months	Over 6 months but less than or equal to 12 months	0.70%
Two	Over 12 months but less than or equal to 23 months	Over 12 months but less than or equal to 24 months	1.25%
	Over 23 months but less than or equal 34 months	Over 24 months but less than or equal 36 months	1.75%
	Over 34 months but less than or equal to 43 months	Over 36 months but less than or equal to 48 months	2.25%
Three	Over 43 months but less than or equal to 52 months	Over 48 months but less than or equal to 60 months	2.75%
	Over 52 months but less than or equal to 68 months	Over 60 months but less than or equal to 84 months	3.25%
	Over 68 months but less than or equal 88 months	Over 84 months but less than or equal 120 months	3.75%
	Over 88 months but less than or equal 112 months	Over 120 months but less than or equal 180 months	4.50%
	Over 127 months but less than or equal to 144 months	Over 180 months but less than or equal to 240 months	5.25%
	Over 144 months but less than or equal to 240 months	Over 240 months	6.00%
	Over 240 months		8.00%

[iii] Specific Risk and General Risk of the Position Risk Component – Traded Debt Instruments - Steps to be followed in the Return

In the Input Sheet of the Return:

[a] identify those financial instruments which fall within the traded debt instruments category and which qualify as **trading book business asset exposures**;

[b] input a description in section 3 (d) of the relevant **trading book business asset exposure**;

[c] input the '*balance sheet value*' and the '*market value*' of the **trading book business asset exposure** in the adjacent columns

[d] qualify the asset as a **trading book business asset exposure** by choosing letter 'Y' from the drop down list which is available in the column titled '*Held with trading intent?*';

[e] input the number of months to maturity in the adjacent column;

[f] where the risk weighting of the **trading book business asset exposure** is determined through the CQSA, depending on the category of asset, choose the applicable option from the drop down list which is available in the column titled '*Credit Quality Assessment*';

[g] input the coupon rate in the final column;

[h] the return will automatically compute both the specific and general risk for traded debt instruments in Sheet 6 and Sheet 7 respectively.

[B.2] Equity

[i] Specific Risk

The **specific risk factor of the position risk component of an equity instrument** is equivalent to the **overall gross position** in equity instruments multiplied by the applicable risk weighting. The overall gross position is defined as the summation of the market values of all long and short positions in equity instruments. In order to establish the risk weighting, the following should be taken into consideration:

- the classification of the equity instrument into either: [a] shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre; and [b] Other Shares [including investments in venture capital firms and private equity investments];
- the applicable risk weighting of the equity instrument, is 2% for equity instruments which fall within classification [a] of the above first bullet point and 4% for equity instruments falling within classification [b] of the above first bullet point.

[ii] General Risk

The **general risk factor of the position risk component of an equity instrument** is equivalent to the overall net position of the equity instrument multiplied by 8%. The overall net position is defined as long positions less short positions in equity instruments. Equity instruments which are classified as: [a] shares traded on an EU Regulated Market or the Regulated Market of a developed financial centre and [b] Other Shares [including investments in venture capital firms and private equity investments] are both assigned a risk weight of 8%.

[iii] Equity Position Risk Component - Steps to be followed in the Return

In the Input Sheet of the Return:

[a] Identify those financial instruments which fall with the equity instruments category and which qualify as **trading book business asset exposures**;

[b] input a description in Section 3 (d) of the relevant **trading book business asset exposure**;

[c] input the '*balance sheet value*' and the '*market value*' of the **trading book business asset exposure** in the adjacent columns;

[d] qualify the asset as a **trading book business asset exposure** by choosing letter 'Y' from the drop down list which is available in the column titled '*Held with trading intent?*';

[e] the Return will automatically compute both the specific and general risk for traded debt instruments in Sheet 8.

[B.3] Collective Investment Schemes

[i] Specific and General Risk

The specific and general risk factor of the position risk component in the case of collective investment schemes is combined. In this case, the position risk component is the equivalent of the market value of the units in the collective investment scheme multiplied by the applicable position risk weighting. In order to establish the risk weighting, the following is taken into consideration:

- the classification of the financial instrument into: [a] investments in high risk collective investment schemes; and [b] other collective investment schemes;
- the applicable risk weighting of the financial instrument, is 16% for collective investment schemes which fall within classification [a] of the above bullet point and 32% for collective investment schemes falling within classification [b] of the above bullet point.

[ii] Collective Investment Scheme Risk Component - Steps to be followed in the Return

In the Input Sheet of the Return:

[a] identify those investments in collective investment schemes which qualify as **trading book business asset exposures**;

[b] input a description of the relevant **trading book business asset exposure**;

[c] input the '*balance sheet value*' and the '*market value*' of the **trading book business asset exposure** in the adjacent columns;

[d] qualify the asset as a **trading book business asset exposure** by choosing letter 'Y' from the drop down list which is available in the column titled '*Held with trading intent?*';

[e] the Return will automatically compute the position risk component for collective investment schemes in Sheet 9.

[4.2.2.2] Settlement Risk – Cash Against Documents

For the purpose these rules, **cash against documents transactions** shall mean transactions where the purchaser takes ownership of the financial instrument the moment cash is handed over to the seller [delivery versus payment].

Settlement risk is the risk that the Licence Holder's **cash against documents transactions** in financial instruments which qualify as trading book business are unsettled after their due delivery dates.

[A] Measuring the Settlement Risk Component

The Settlement Risk Component is the equivalent of the difference between the agreed settlement price and the current market value of a financial instrument which qualifies as trading book business and whose payment is unsettled after its due delivery date, multiplied by the relevant risk weight. The applicable risk weights are outlined in the following table:

Number of working days after the due settlement date	Risk Weight
5-15	8%
16 - 30	50%
31 – 45	75%
46 or more	100%

[B] Settlement Risk Component - Steps to be followed in the Return

In the Input Sheet of the Return:

Debtors – Unsettled Securities transactions - cash against documents

[i] identify those financial instruments which have been delivered by the Licence Holder and which qualified as trading book business but for which payment is still due after delivery date;

[ii] identify the cash amounts which have been settled by the Licence Holder in respect of undelivered financial instruments and which qualified as trading book business/cash against documents;

[iii] categorise in the **section 3 (e) (i)** of the input sheet the **unsettled securities transactions**, identified in [i] and [ii] above, under one of the available headings, which headings reflect the headings in the above table;

[iv] enter the **balance sheet value** of the amount due to the Licence Holder and in the adjacent column include the **current market value**.

[v] the Return will automatically compute the relevant settlement risk component in Sheet 10.

[4.2.2.3] Counterparty Risk Component

For the purpose of these Rules, counterparty risk is the amount of capital which the Licence Holder must hold against exposures in financial derivative instruments and credit derivatives (which can be defined as a contract between two parties that allows for the use of a derivative instrument to transfer credit risk from one party to another).

N.B. These Rules and the Return do not cater for the calculation of the trading book business Counterparty Risk Component. As it is generally the exception that Licence Holders invest in derivatives, the MFSA has taken the approach that the calculation of the counter party risk related to investments in such assets may be catered for on a case by case basis. Licence Holders who invest in derivatives should contact the MFSA for guidance as to how the counterparty risk component should be calculated and catered for in the Return.

[4.2.2.4] Free Deliveries

For the purpose these Rules, **free deliveries transactions** shall mean **non delivery versus payment** transactions in financial instruments.

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.

[A] Measuring Free Deliveries

Both where: [i] financial instruments which fall within the definition of trading

book business were delivered by the Licence Holder prior to receiving payment, or [ii] where the Licence Holder has paid for the financial instruments which fall within the definition of trading book business; the applicable free deliveries risk factor is calculated as follows:

Multiply the market value of the financial instrument by the applicable discount factor as detailed in the following table:

Period	Risk Discount Factor
Up to first payment / delivery leg	0%
From first payment / delivery leg to four days after second payment / delivery leg	8%
From five business day post payment / delivery leg until extinction of transaction	100%

[B] Free Deliveries - Steps to be followed in the Return

In the Input Sheet of the Return:

Debtors – Unsettled securities transactions – free deliveries

[i] identify those financial instruments which have been delivered by the Licence Holder and which qualified as trading book business/free deliveries but for which payment is still due after delivery date;

[ii] identify the cash amounts which have been settled by the Licence Holder in respect of undelivered financial instruments which qualified as trading book business/free deliveries;

[iii] categorise in the **section 3 (e) (ii)** of the input sheet the **unsettled securities transactions**, identified in [i] and [ii] above, under one of the available headings, which headings reflect the heading in the above table;

[iv] enter the **balance sheet value** of the amount due to the Licence Holder and in the adjacent column include the **current market value**;

[v] the Return will automatically compute the relevant free deliveries risk component in Sheet 11.

[4.2.3] Commodities Instruments - Risk Component

Commodities Risk is the risk component required to cover the Licence Holder's 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.

Some traditional examples of commodities include grains, gold, beef, oil and natural gas. More recently, the definition has been expanded to include: (a) financial products such as foreign currencies and indices, and (b) cell phone minutes and bandwidth.

[A] Measuring the Commodities Instruments - Risk Component:

Steps to measure the Commodities Risk Component:

- [i]** identify the commodity positions;
- [ii]** express each position in terms of the standard unit of measurement of the commodity concerned [for example barrels of oil] ;
- [iii]** calculate the individual commodity risk for each commodity position by summing 15% of the net position [long – short] of standard unit of measurement;
- [iv]** multiply the result as per **[iii]** by the spot price of the commodity;
- [v]** calculate the individual commodity risk for each commodity position by summing 3% of the gross position [long + short] of standard unit of measurement;
- [vi]** multiply the result in as per **[v]** by the spot price of the commodity;
- [vii]** add the resulting figure as per **[iv]** and **[vi]** above to obtain the risk component for each individual position;
- [viii]** the Commodities instruments - risk component is equivalent to the result of the sum of each individual position.

[B] A Licence Holder's commodities instruments - risk component calculation shall include the following items:

- [i]** forwards, futures, contracts for differences, synthetic futures and options on a single commodity;
- [ii]** a commitment to buy or sell a single commodity at an average of spot prices prevailing over some future period;
- [iii]** forwards, futures contracts for differences, synthetic futures and options on a commodity index; and
- [iv]** commodity swaps.

[C] **Commodities Instruments – Risk Component - the Return**

N.B. The Return does not cater for the Commodities Instruments - Risk Component. As Licence Holders rarely invest in commodities or commodity derivatives, risk related to investments in such assets may be catered for on a case by case basis. Licence Holders who invest in commodities or commodity derivatives should contact the MFSA for guidance as to how the commodities instruments - risk component should be catered for in the Return.

[4.2.4] **Large Exposures Risk Component**

The purpose of the large exposure requirement is to ensure that a firm manages its exposure to counterparties within appropriate limits set in relation to its capital resources requirements. A large exposure may be in the form of a loan to a single borrower, or it may arise across many transactions involving different types of financial instruments with several counterparties.

A large exposure means the exposure to: **(a) an individual counterparty; (b) connected counterparties; or (c) a group of connected clients** (all three terms are defined in point [A] below).

Condition regarding Individual Large Exposures

Licence Holders are to adopt policies within which exposures to any class of the above-mentioned categories of counterparties do not exceed 25% of their Own Funds.

The Large Exposures Risk Component shall be the equivalent of the summation of the amount which is in excess of the above-mentioned 25% limit.

Condition regarding Total Individual Large Exposure

Licence Holders are to adopt policies wherein the total of individual exposures exceeding 10% of Own Funds are not to exceed 800% of their Own Funds. Licence Holders shall monitor and control their large exposures to ensure that the total large exposures does not exceed this limit.

[A] **Types of Counterparties**

[i] **Individual Counterparties**

An **individual counterparty** may be either a natural or a legal person. Examples of counterparties include:

- (a) **the client** which includes governments, local authorities, public sector entities, individual trusts, corporations, unincorporated businesses and non-profit making bodies and individual clients;
- (b) where the Licence Holder is providing a guarantee, **the person guaranteed;**
- (c) for a derivatives contract, **the person with whom the contract was made;**

and

- (d) **the company** in which a Licence Holder acquires shares which are traded on a regulated market either as principal or on behalf of clients.

[ii] Groups of Connected clients

A group of connected clients is defined as one of the following either:

- (a) two or more persons who unless proved otherwise constitute a single risk because one of them is the parent undertaking of the other/s; or
- (b) two or more persons who do not have the relationship as defined in (a) but who are regarded as constituting a single risk because they are so interconnected that if a member were to encounter financial difficulties the other members are likely to face repayment difficulties. Relationships between individual counterparties which might be considered to constitute a single risk for the purposes of the definition of group of connected clients include: schemes in the same group; companies whose ultimate owner (whether wholly or significantly) is the same individual or individuals, and which do not have a formal group structure; companies having common directors or management; and counterparties linked by cross guarantees.

[iii] Connected counterparties

For the purpose of the calculation of large exposure risk component, connected counterparty means another person ('P') to whom the Licence Holder has an exposure and who fulfils at least **one** of the following conditions:

- (a) P is closely related to the Licence Holder; or
- (b) P is an associate of the firm; or
- (c) the same persons significantly influence the governing body of P and the Licence Holder; or
- (d) the Licence Holder has an exposure to P that was not incurred for the clear commercial advantage of the Licence Holder and which is not on an arm's length basis.

[B] Measuring the Large Exposures Risk Component / The Return

- [i] classify the Licence Holder's exposures under one of the categories of counterparties mentioned in [A] above. By way of example, classify a company in which the Licence Holder has an investment as either an **individual counterparty**; or a **connected counterparty**; or a **group of connected clients**;
- [ii] report in **sheet 12** all the Licence Holder's individual counterparty exposures which exceed **10%** of own funds;
- [iii] **the Return will automatically calculate the large exposures risk component in Sheet 12.**

[C] **Large Exposures - Exempt Exposures**

The following exposures are fully or partially exempt from the calculation of the individual and total large exposure calculation:

Exempt Exposures	Proportion Exempt
(a) asset items constituting claims on central governments or central banks which, unsecured, would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
(b) asset items constituting claims on international organisations or multilateral development banks which, unsecured, would be assigned a 0% risk weight under Credit/Counterparty Risk Calculation;	100%
(c) asset items constituting claims carrying the explicit guarantees of central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity providing the guarantee would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
(d) other exposures attributable to, or guaranteed by, central governments, central banks, international organisations, multilateral development banks or public sector entities, where unsecured claims on the entity to which the exposure is attributable or by which it is guaranteed would be assigned a 0% risk weight under the Credit/Counterparty Risk Calculation;	100%
(e) asset items constituting claims on and other exposures to central governments or central banks not mentioned in point (a) which are denominated and, where applicable, funded in the national currencies of the borrowers;	100%
(f) asset items and other exposures secured to the satisfaction of the MFSA, by collateral in the form of debt securities issued by central governments or central banks, international organisations, multilateral development banks, member states' regional governments, local authorities or public sector entities, which securities constitute claims on their issuer which would receive 0% risk weighting under the Standardised Approach to credit/counterparty risk;	100%
(g) asset items and other exposures secured, to the satisfaction of the MFSA, by collateral in the form of cash deposits placed with the lending credit institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution;	100%

asset claims and other exposures secured to the satisfaction of the authority, by collateral in the form of certificates of deposits issued by the lending credit institution or by a credit institution which is the parent undertaking or subsidiary of the lending credit institution and lodged with either of them;	100%
(h) asset items constituting claims on and other exposures to credit institutions or investment firms, with a maturity of one year or less, but not forming part of their Own Funds;	100%
(i) trade bills availed by a prime credit institution with a maturity of twelve months or less;	100%
(j) exposures to prime credit institutions with a maturity of over one year but not more than three years;	80%
(k) exposures to prime institutions of over three years' maturity in the form of debt instruments issued by a prime institution provided such instruments are effectively negotiable in a professional market and are subject to a daily quotation on that market;	50%
(l) Asset items constituting claims on EEA states regional government and local authorities where such claims receive a zero risk weight under the standardised approach to credit/counterparty risk.	100%

[4.2.5] Foreign Exchange Risk Component

Foreign Exchange Risk is 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.

N.B. These Rules and the Return provide for the calculation of the Foreign Exchange Risk component of all types of asset exposures except for derivatives. As Licence Holders rarely invest in derivatives, MFSA has taken the approach that for the purpose of the Return, the calculation of the risk related to investments in such assets may be catered for on a case by case basis. Licence Holders which transaction in derivatives should contact the MFSA for guidance as to how the derivatives related foreign exchange risk component should be calculated and catered for in the Return.

[A] To calculate its foreign exchange risk component which will form part of the applicable capital resources requirement, a Licence Holder shall identify the foreign currencies to which it is exposed and then calculate the open currency position by:

[i] calculating the net [long/short] open currency position in each foreign currency to which the Licence Holder is exposed;

[ii] converting each net open position into its base currency equivalent at current spot rates;

[iii] summing all short net positions and summing all long net positions and selecting the larger sum; and

[iv] multiplying the sum of the net open currency position in base currency equivalent by 8%.

[B] A Licence Holder’s foreign exchange risk component calculation shall include the following items regardless whether they are trading book business positions or non-trading book business positions or commodity positions:

[i] all financial instruments which are denominated in a foreign currency;

[ii] all spot positions in foreign currency (including accrued interest); and

[iii] other assets/liabilities including gold positions.

[C] Foreign Exchange Risk Component - Steps to be followed in the Return

[i] identify those asset exposures denominated in a currency other than the currency in which the financial statements are prepared;

[ii] categorise these exposures in sheet 13 of the Return under one of the available sub-headings. Input the forex exposure in each currency under one of the available columns;

[iii] in section 3 of sheet 13 input the exchange rate converting the foreign currency to reporting currency;

[iv] the Return will automatically compute the relevant foreign exchange risk component in Sheet 13.

[4.2.6] Operational Risk Capital Requirement

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.

The operational risk capital requirement (“ORCR”) for a Licence Holder is an amount calculated in accordance with one of the following methods:

- I. The Basic Indicator Approach [‘BIA’];
- II. The Standardised Measurement Approach [‘SMA’]; and
- III. The Advanced Measurement Approach [‘AMA’]

N.B. These Rules cater for the Basic Indicator Approach. A explanation on how to apply the SMA and the AMA approaches and the applicable qualifying criteria to use both methods will be provided by the MFSA upon request.

[A] The ORCR as calculated by the BIA is equivalent to 15% of the relevant indicator which is defined hereunder:

[i] The **relevant indicator** is defined as the three year average of the sum of the Licence Holder's (a) net interest income; and (b) net non-interest income.

[ii] The three year average must be calculated on the basis of the last three yearly observations at the end of the financial year. Where audited figures are not available, business estimates may be used.

[iii] If the sum of (a) and (b) above is negative or equal to zero, this figure must be excluded from both the numerator and denominator when calculating the three year average. The relevant indicator shall be calculated as the sum of **positive figures** divided by the number of **positive figures**.

[iv] The **relevant indicator** shall be expressed as the sum of elements listed hereunder. Each element must be included in the sum with a positive or negative sign.

- (a) Interest receivable and similar income
- (b) Interest payable and similar charges
- (c) Income from shares and other variable/fixed-yield securities
- (d) Commissions/fees receivable
- (e) Commissions/fees payable
- (f) Net profit or net loss on financial operations
- (g) Other operating income

[v] Considerations prior to calculating the Relevant Indicator

- (a) For the purpose of the above calculation, any income from a participation held in an undertaking of the Licence Holder, is not to be included in the relevant indicator calculations, thereby ensuring that intra-group dividends and other intra-group income flows are not double counted;
- (b) Furthermore, any income received under an operating lease, should be included as gross income less depreciation and not as gross rental income;
- (c) The relevant indicator must be calculated before the deduction of any provisions and operating expenses;
- (d) Operating expenses shall include fees paid for outsourcing services rendered by third parties. These third parties should not be (i) a parent or subsidiary of the Licence Holder or (ii) a subsidiary of a parent company which is also the parent of the Licence Holder. Expenditure on the outsourcing of services rendered by third parties will reduce the relevant indicator if such expenditure is incurred by a company licensed in terms of the Investment Services Act, 1994. **Outsourcing** may be defined as a Licence Holder's use of a third party to perform activities on a continuing basis that would normally be undertaken by the Licence Holder now or in future;
- (e) The following elements shall **not** be used in the calculation of the relevant indicator:
 - (a) Realised profits/losses from the sale of non-trading book items;
 - (b) Income from extraordinary or irregular items; and
 - (c) Income derived from insurance.
- (f) When revaluations of trading items forms part of the income statement,

such revaluations could be included in the calculation of the relevant income indicator.

[B] Operational Risk - the Return

N.B. The Return does not cater for the Operational Risk Component. As this requirement only applies to Category 3 Licence Holders, MFSA decided that for the purpose of the Return, the calculation of the operational risk component may be catered for on a case by case basis. Category 3 Licence Holders should contact the MFSA for guidance as to how the operational risk component should be catered for in the Return.

[4.3] Fixed Overheads Requirement

The fixed overheads requirement is calculated by taking, in the case of:

- [i] the annual figures, one quarter of the Licence Holder's yearly total expenditure after deducting the items of expenditure outlined in point (4.3.1) below; and
- [ii] the quarterly/half yearly figures [as and where applicable] by: [a] deducting the items of expenditure outlined in point [A] below from total expenditure to obtain the **relevant expenditure figure** [b] extrapolating the relevant expenditure figure for the quart/half yearly, as applicable, into an annual figure to obtain the **pro-rated annualised expenditure figure**, and [c] taking one quarter of the pro-rated annualised expenditure figure.

[A] The following items of expenditure are to be deducted from the total expenditure reported in the Income Statement: (a) *staff bonuses*, (b) *employees and directors' shares in profits*, (c) *allowable commissions and fees [meaning commissions and fees payable, provided they are directly attributable to commission and fees receivable which are included in total revenue]*, (d) *interest charges in respect of borrowing made to finance the acquisition of the Licence Holder's readily realisable investments*, (e) *interest paid to clients on client's money* (where applicable), (f) *interest paid to counterparties*, (g) *fees, brokerage and intermediate brokers for the purposes of executing, registered or clearing transactions*, (h) *foreign exchange losses*, (i) *other variable expenses*, (j) *Depreciation*, and (k) *exceptional expenditure (with the MFSA prior approval)*.

[B] Fixed Overheads Requirement – The Return

Input the items of expenditure in section 2 of the input sheet. The Return will automatically calculate the fixed overheads requirement in Sheet 14.

ANNEX 1: Specimen Subordinated Loan Agreement

THIS SUBORDINATED LOAN AGREEMENT

is made the day of 20 between

(1) [] of []
("the Lender");

(2) [] of []
("the Borrower"); and

(3) The Malta Financial Services Authority established under the Malta Financial Services Authority Act, Cap 330 ("the MFSA")

WHEREAS

- (A) The Borrower is a Licence Holder under the Investment Services Act, 1994.
- (B) The Borrower is required to maintain financial resources to meet the provisions of its licence as they apply to the Borrower at any particular time.
- (C) The Lender has agreed to lend to the Borrower an amount as set herein upon and subject to the terms and conditions contained in this Agreement.

NOW IT IS HEREBY AGREED as follows:

1. The Loan

- (a) On completion of this Agreement, the Lender hereby advances to the Borrower by way of loan the principal amount of [] (the "Principal Amount") upon and subject to the terms and conditions contained in this Agreement.
- (b) Each of the Lender and the Borrower hereby undertakes with the MFSA that forthwith upon request by the MFSA it will provide to the MFSA details in writing of all principal and interest in respect of the Loan outstanding for the time being and all payments of any amount made in the period specified by the MFSA in the request.

2. Interest

Subject to the provisions of Clause 5 of this Agreement:

The Borrower shall until repayment of the Loan in full pay to the Lender annual interest on the Loan or on any part or parts thereof for the time being remaining due hereunder.

Provided that at no time during the continuance of this Agreement shall the Rate of Interest exceed an annual rate of [8% or other maximum rate set by the MFSA].

3. Prepayment

Subject to the provisions of Clause 5 of this Agreement, the Borrower may prepay the whole or any part of the Loan provided that the written consent of the MFSA to such prepayment is first obtained by the Borrower.

4. Repayment of the Loan

Subject to the provisions of Clause 5 of this Agreement, the Loan shall be repayable provided that prior written notice has been given to the MFSA and the prior written consent of the MFSA to such repayment has been obtained by the Borrower.

5. Subordination

Notwithstanding the provisions of Clauses 3 and 4 of this Agreement, the rights of the Lender in respect of the Loan are subordinated in all respects to all the creditors of the Borrower in respect of amounts outstanding to them payable by the Borrower ("Senior Liabilities") and accordingly payment of any amount of the Loan shall be in all respects conditional on the express prior written consent of the MFSA to such payment provided that payments of interest may be made without such consent at a rate not exceeding the rate provided in the proviso to Clause 2 of this Agreement.

6. Payments

Subject to the provisions of Clause 5 of this Agreement all sums payable by the Borrower hereunder shall be paid in full without set off or counter claim and free and clear of and without deduction or withholding for or on account of any present or future taxes, duties or other charges. If any payment shall be subject to any such tax or if the Borrower shall be required by law to make any such deduction or withholding, the Borrower will pay such tax, will ensure that such payment, deduction or withholding, will not exceed the minimum legal liability therefore and will simultaneously pay to the Lender such additional amounts as will result in the Lender receiving a net amount equal to the full amount which the Lender would have received had no such payment, deduction or withholding been required.

7. Covenants

(a) The Borrower hereby undertakes to the MFSA that it will not without the prior written consent of the MFSA:

(i) secure all or any part of the Loan;

- (ii) redeem, purchase or otherwise acquire any of the liabilities of the Borrower in respect of the Loan;
 - (iii) amend or concur in amending the terms of this Agreement;
 - (iv) repay all or any part of the Loan otherwise than in accordance with the terms hereof; or
 - (v) take or omit to take any action whereby the subordination of the Loan or any part thereof as provided for in Clause 5 of this Agreement might be terminated, impaired or adversely affected.
- (b) The Lender hereby undertakes to the MFSA that it will not without the prior written consent of the MFSA:
- (i) assign or purport to assign to any person this Agreement or the whole or any part of its rights against the Borrower in respect of the Loan;
 - (ii) purport to retain or set off at any time any amount of the Loan against any amount otherwise payable by it to the Borrower except to the extent that payment of such amount of the Loan would be permitted at such time by this Agreement;
 - (iii) amend or waive or concur in amending or waiving the terms of this Agreement;
 - (iv) attempt to obtain repayment of the whole or any part of the Loan otherwise than in accordance with the terms of this Agreement;
 - (v) take or omit to take any action whereby the subordination of the Loan or any part thereof as provided for in Clause 5 of this Agreement might be terminated, impaired or adversely affected; or
 - (vi) take any security from any person for all or any part of the Loan and so that the Lender shall, upon obtaining security in breach of this Clause, hold the same for the Borrower.

8. Entire Agreement

The Borrower, the Lender and the MFSA acknowledge that this Agreement forms the entire agreement relating to the Loan. If there are any other terms relating to the Loan existing at the date hereof and not comprised in this Agreement such terms shall be of no further force and effect. Any amendments to this Agreement made or purported to be made without the written consent of the MFSA shall be void.

9. Continuing Obligations

The obligations of the Borrower and Lender hereunder shall be continuing obligations and shall be and remain fully effective until the repayment of the Loan in full in accordance with the provisions of this Agreement.

10. MFSA

The MFSA is party to this Agreement only for the purpose of ensuring the enforceability of the provisions of this Agreement so as to satisfy itself that the relevant requirements of the financial resources are met and the MFSA is not, and shall not be deemed to be under any duty to, or to have any obligation of any nature to, the other creditors of the Borrower or any of them.

Each of the Lender and the Borrower shall indemnify the MFSA against all claims, losses, costs, expenses and other liabilities made against or incurred by the MFSA as a consequence of the MFSA being a party to, or taking any action under, this Agreement.

The parties hereby signify their consent and understanding of the above provisions.

ANNEX II: Specimen Qualifying Undertaking

THIS UNDERTAKING IS ENTERED INTO

THE DAY OF 20 BETWEEN

- (1) [] of [] (“the Guarantor”)
- (2) the Malta Financial Services Authority established under the Malta Financial Services Authority Act, Cap 330 (“the MFSA”); and
- (3) [] of [] (“the Principal”)

WHEREAS

- (A) The Principal is a Licence Holder.
- (B) The Principal is required to maintain Financial Resources to meet the provisions of its Investment Services Licence in accordance with the Investment Services Act, 1994, and the MFSA has agreed that the Financial Resources Requirements may in part be represented by one or more undertakings in the form hereof.
- (C) The Principal has requested the Guarantor to give an undertaking to the MFSA for the purposes of the Principal’s Financial Resources Requirements which the Guarantor has agreed to do.

NOW THESE PRESENT WITNESS and it is hereby agreed and declared as follows:

- 1. In this Undertaking :
 - “Liabilities” means all present and future sums, liabilities and obligations payable or owing by the Principal (whether actual or contingent, jointly or severally or otherwise howsoever); and
 - “Financial Resources Requirements” means the financial resources requirements which the Principal is, pursuant to its Investment Services Licence, required to maintain at any particular time;
- 2. (a) In consideration of the MFSA agreeing to take this Undertaking into account for the purpose of determining compliance by the Principal with its Financial Resources

Requirements, the Guarantor HEREBY UNDERTAKES with and to the MFSA and the Principal that at any time after the occurrence of any Event of Default specified below and notwithstanding that any other Event of Default may have occurred prior thereto the Guarantor will on demand in writing made upon it by the MFSA pay to the Principal the sum of [] into such account of the Principal as the MFSA may specify.

- (b) The following shall be Events of Default for the purposes of this Agreement:
- (i) the Principal is unable or admits its inability to pay its debts as they fall due or makes a general assignment for the benefit of, or a composition with, its creditors;
 - (ii) a liquidator or curator in bankruptcy or administrator, or similar officer is appointed, of all or any part of the undertaking or assets of the Principal;
 - (iii) the Principal shall, in the opinion of the MFSA, be in breach of its Financial Resources Requirements and, in the opinion of the MFSA, shall not have remedied such breach within 5 working days after being required by the MFSA to restore the deficiency.
3. The MFSA may without notification to or the consent of the Guarantor and without affecting or discharging the Guarantor's liability or releasing the Guarantor from its obligations from time to time waive or omit or fail to exercise or delay exercising its rights in respect of any Event of Default and any such waiver, omission, failure or delay shall not prejudice or affect the MFSA's rights in this Agreement in respect of that Event of Default (except in the case of a waiver) or any other or further Event of Default.
4. This Undertaking shall be a continuing undertaking and shall apply irrespective of, and shall not be affected or discharged by, any matter relating to the compliance at any time by the Principal with its Financial Resources Requirements or that the Principal at any time complies or is able to comply with the Financial Resources Requirements without making use of this Undertaking or taking the same into account for the purposes of its Financial Resources Requirements.
5. This Undertaking shall apply in relation to any Event of Default occurring at or before the close of business on the termination date, being a date specified by the Guarantor giving the MFSA not less than six months' written notice of its desire to terminate this Undertaking. Such notice shall only be able to be given on or after the second anniversary of the signing of this Undertaking.
- Provided that no demand may be made upon the Guarantor under this Agreement later than midnight on the thirtieth Business Day after the Termination Date.
6. If the MFSA requires the Principal to remedy a breach of its Financial Resources Requirements as referred to in paragraph 2(b)(iii) hereof, it shall notify the Guarantor thereof as soon as reasonably practicable thereafter.
7. The rights of the Guarantor to repayment of any sums paid to the Principal under the

terms of this Undertaking are subordinated to the other Liabilities and accordingly repayment of any such sums is conditional upon the prior payment of the other Liabilities.

8. This Undertaking forms the entire Agreement as to the agreement of the Guarantor to provide an undertaking in relation to the Principal's Financial Resources Requirement. If there are any other terms relating thereto existing at the date hereof and not comprised in this Undertaking such terms shall be of no further force and effect. No variation of or amendment to this Undertaking shall be of any effect unless it is in writing subscribed by all the parties hereto. Any amendment to this Undertaking made or purported to be made without the consent of MFSA shall be void.

The parties hereby signify their consent and understanding of the above provisions.

Note:-

Where the Principal is not a company, the provisions of the Undertaking should (in agreement with the MFSA) be amended as appropriate to reflect the legal status of the Principal.

ANNEX III: Specimen Bank Guarantee

[To be addressed to MFSA by the Bank, with a copy of same to the applicant/Licence Holder]

The Malta Financial Services Authority and Licence Holder

Dear Sirs,

Our guarantee No. _____ for Lm _____
Account: _____ (Name of third party provider of security)

In consideration of Malta Financial Services Authority (hereinafter referred to as “MFSA”) agreeing to take this Bank guarantee into account for the purposes of determining compliance by _____ (name of licence holder not provider of security) (hereinafter referred to as the “Licence Holder”) with its Financial Resources Requirement for the issue/maintenance of its Investment Services Licence, we hereby guarantee the payment to the Licence Holder of the maximum sum of Lm _____ on receipt of a first demand in writing by both MFSA and Licence Holder jointly or by MFSA solely in which second case the claim must be accompanied by MFSA’s written declaration stating the Licence Holder is in breach of its Financial Resources Requirements.

This guarantee becomes payable on first demand and it shall not be incumbent upon us to verify whether such demand is justified. This guarantee shall be payable into the Licence Holder’s account with us unless the claim effected as aforesaid directs otherwise.

We undertake not to seek reimbursement for any payment effected under this guarantee from the Licence Holder.

This guarantee shall continue in force irrespective of any waiver MFSA may concede to the Licence Holder in respect of any breach of its Financial Resources Requirements from time to time.

This guarantee remains in force up to _____ but will be extended by us automatically for further periods of one year each unless returned to us for cancellation before that date. Our liability hereunder may be determined by notice in writing advised to both Licence Holder and MFSA whereupon this guarantee will expire six months after date of receipt of such notice by MFSA. Any demand made hereunder for payment must be received at this Office in writing not later than either the expiry date aforementioned or the expiry date of an extension period as the case may be.

This document should be returned to us for cancellation on utilisation or expiry or in the event of the guarantee being no longer required.

After the expiry date and in the absence of a written demand being received by us before such

expiry date, this guarantee shall be null and void, whether returned to us for cancellation or not, and our liability hereunder shall terminate.

This guarantee is not assignable.

Yours faithfully,

MANAGER

COUNTERSIGNED