MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Securities and Markets Supervision Unit

Unit Tel: (+356) 21441155
Unit Fax: (+356) 21449308

13 May 2015

To: Fund Managers

Attn: Compliance Officer

By e-mail

Dear Sir/ Madam,

Re: (a) Inclusion of Retained Earnings as part of Own Funds' Computation

The Authority would like to bring to your attention the following rule regarding the inclusion of retained earnings as part of the own funds computation: Section 3.1.1.1 (A) (iii) of Appendix 1A of the Investment Services Rules for Investment Services Providers, which states:

"For the purposes of this point, Licence Holders shall include interim or year-end profits before a formal decision has been taken only if these profits have been verified by persons responsible for the auditing of the accounts (i.e. external auditors) and if it is proved to the satisfaction of the Authority that the amount thereof has been evaluated in accordance with International Financial Reporting Standards as adopted by the European Union.

Interim or year-end profits shall be included after deduction of any foreseeable charge, tax or dividend. Licence Holders should refer to the Regulatory Technical Standards on Own Funds for the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted."

This rule emanates from Article 26(2) of the Capital Requirements Regulation (Regulation (EU) No 575/2013 – "the CRR"), which is applicable to fund managers via the definition of own funds laid down in the Alternative Investment Fund Managers Directive (Directive 2011/61/EU – "the AIFMD") and in the Undertakings for Collective Investment in Transferable Securities Directive (Directive 2009/65/EC – "the UCITS Directive"). In order for Licence Holders to ensure that the interim or year-end profits (which have not yet been subject to audit) qualify as regulatory capital, they must take the necessary steps to ensure that these profits have been **verified** by the auditors. Putting it differently, in the absence of verification by the auditors, interim and year-end profits are **not** to be included as part of the own funds' computation.

As stated in Article 26(2) of the CRR, *"a verification of the interim or year-end profits of the institution shall provide an adequate level of assurance that those profits have been evaluated in accordance with the principles set out in the applicable accounting framework."*

For further guidance on the inclusion of interim profits in own funds, Licence Holders are required to refer to the European Banking Authority's Q&A (Question ID: 2013_384), which is attached for your perusal.

Please note that going forward, the Authority will be monitoring the inclusion of interim and year-end unaudited profits as part of own funds and it will be undertaking random checks to ensure that Licence Holders have the necessary auditor verification on file (in cases where such profits are being reported as part of Own Funds). Moreover, checks will also be undertaken during regulatory onsite compliance visits carried out by the Authority. Needless to say, the Authority will take a very serious view should own funds be misreported as a result of the inclusion of interim or unaudited year end profits which are not duly supported by auditors' verification as required by the CRR.

(b) Appendix 2B – Financial Return for Fund Managers

When completing the Financial Return, Fund Managers are expected to input the profits made during the year (and which have not yet been subject to audit but which have been **verified** by the auditors) in Section 6(j) of the Input Sheet:

j) The Financial Return is showing a Profit or Loss of:	-
Kindly input the profits which been verified by persons independent of the institution that are responsible for the auditing of the accounts of that institution	

The Authority published the revised version of the Financial Return (with the above update) on 1 April 2015. Please ensure that you adopt the revised template for any reports after this date and submit as part of your Financial Return reporting package. The only change from the previous version is the addition of a section 6(j) in Sheet 1 where licence holders are required to input the reported profits which have been subject to verification by the external auditor as indicated in sections (a) and (b) above

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Contacts

Please refer any queries relating to the CRD IV/CRR framework and other supervisory matters as set out below:

Nature of Query	Official	Contact details
CRD IV regulatory framework	Ms Mellyora Ellul	mellul@mfsa.com.mt
Off-site compliance	Mr Christopher Micallef	cmicallef@mfsa.com.mt
The Financial Return 2B	Mr Andrew Said	asaid@mfsa.com.mt

It is very important that regulatory returns are completed accurately and submitted within the timeframes set by the Authority.

Sincerely,

Dr Christopher P. Buttigieg
Director
Securities and Markets Supervision Unit

MFSA: Attachment to MFSA Letter dated 25 March 2015 regarding the European Banking Authority's Final Q & A on the inclusion of interim profits – Attachment No 1

Question ID:	2013_384
Legal act :	Regulation (EU) No 575/2013 (CRR)
Topic :	Own funds
Article:	26(2) / 36(1)(a)
Paragraph:	
Subparagraph:	
Article/Paragraph :	-
COM Delegated or Implementing Acts/EBA RTS/EBA ITS/EBA GLs:	Not applicable
Subject matter :	Inclusion of interim profits / Deduction of losses in own funds
Question:	1. How should the interim profits be calculated for the purposes of inclusion in own funds? E.g. if the bank has monthly P/L as follows: Jan -10, Feb -20, March +100 (Year-to-date +70). The results are not verified by external audit. Should the bank take deduct the losses from Jan and Feb, but ignore the March gain as it is unaudited (capital impact compared to IFRS equity -100) or can the losses be netted with the gains and the YTD gain (unaudited) be filtered out (capital impact -70)? 2. What constitutes 'adequate level of assurance' in context of verification by external auditors? Is a full audit required or is an interim review sufficient?
Background on the question:	P/L is calculated on various frequencies (monthly, quarterly, half-yearly). The gains and losses can offset (gain in one month can turn an YTD loss to a profit) and due to the asymmetrical treatment of gains and losses (no audit requirement for losses), the eligibility of the interim profits in own funds is not clear.
Date of submission:	13/10/2013
Published as Final Q&A:	20/02/2015

EBA answer:	1. For the purposes of Article 26(2) of Regulation (EU) No. 575/2013 (CRR), interim profits can only be included in Common Equity Tier 1 (CET1) capital with the prior permission of the competent authority if those profits have been verified by the external auditor and if any foreseeable charge or dividend has been deducted. In the example above, assuming that the bank has a December year-end, the relevant figure to be considered for inclusion in CET1 capital at end-March is 0, i.e. not including the net interim profit of +70 generated from January to March, as these have not been verified by an external auditor. Therefore, the amount of the interim profit to consider at the end of March is the amount generated since the end of the last financial year. Although the example given in the question does not reflect the typically quarterly reporting frequency, the principle to be applied is the same, regardless of the reporting frequency. It is expected that for cases corresponding to the specific example in the question, i.e. where interim losses incurred in earlier periods are followed by subsequent **unverified** interim profits, this is subject to some supervisory scrutiny. Institutions shall maintain own funds requirements at all times pursuant to Article 92(1) of the CRR and Article 13(1) of the Commission Delegated Regulation (EU) No 241/2014, which states that 1cfor the purpose of calculating its Common Equity Tier 1 capital during the year, and irrespective of whether the institution closes its financial accounts at the end of each interim period, the institution shall determine its profit and loss accounts and deduct any resulting losses from Common Equity Tier 1 items as they arise 1d. Following the example above, with the institution calculating own funds on a monthly basis, it is therefore required to make deductions from its CET1 capital of -10 and -20 in January and February respectively. 2. Verification of the interim profits of an institution shall be undertaken as frequently as that institution requests permission from their competent authorities to include interim profits in Common Equity Tier 1 capital before the institution has taken a formal decision confirming the final profit or loss of the institution for the year. Adequate level of assurance to be sought by an institution involves at least a review of interim financial information by the external auditor of the annual accounts of that institution in order to express a conclusion whether, on the basis of the review, the interim financial information subject to the review have been prepared, in all material respects, in accordance with the applicable accounting framework. The review should cover any material deviation from the accounting policies applied in the last audited financial statements.