MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CONSULTATION DOCUMENT

CONSULTATION ON THE PROPOSED AMENDMENTS TO BANKING RULE 9 'MEASURES ADDRESSING CREDIT RISKS ARISING FROM THE ASSESSMENT OF THE QUALITY OF ASSET PORTFOLIOS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994'

[MFSA REF.: 11-2016]

30th September 2016

Closing Date: 21 October 2016

Note for Consultation

1. Purpose:

The purpose of this document is to consult on proposed amendments to Banking Rule 09 issued under the Banking Act (1994) with the aim of setting up a framework to incentivise credit institutions to resolve their non-performing loans. This consultation is accompanied by a copy of the said BR09, which for ease of reference presents the proposed amendments in tracked changes. The two documents are therefore an integral part of this consultation and are to be read in conjunction with each other.

2. Background

Asset quality of banks in the EU has improved greatly in 2015 however impaired and past due loans still represent, on average, 5.7% (March 2016). This level remains higher than in other major developed countries[1], in fact the World Bank reported non-performing loan ratios ('NPL') of less than 2% for the United States and Japan at the end of 2015.

The average NPL ratio for core banks in Malta stood at 8.86% (December 2015), significantly higher than the average ratio within the EU. Apart from the credit risks and potential higher cost of capital at micro level, high NPLs are also sources of macro and financial stability risks. Indeed on a systemic scale, high NPLs are known to hinder the efficient channelling of credit to the real economy as well as threatening future profitability at an industry level.

For these reasons following discussions with the Central Bank of Malta ('CBM') and the MFSA, the Joint CBM/MFSA Financial Stability Board ('JFSB') recommended a more direct approach to tackle this phenomenon in Malta, which in turn led to the proposed BR09 amendments under consultation.

Reflecting the focus on the issue of high NPLs, the amendments to BR09 are being proposed at the same time as the European Central Bank ('ECB') consultation on guidance to banks on non-performing loans[2]. The proposed BR09 amendments are very much in line with the ECB guidance. In fact the ECB guidance recommends banks with a high level of NPLs to

[1] European Parliament Briefing – Non-performing loans in the Banking Union: stocktaking and challenges, 18 March 2016.
[2] https://www.bankingsupervision.europa.eu/press/pr/date/2016/html/sr160912.en.html

establish a clear strategy aligned with their business plan and risk management framework to effectively manage and ultimately reduce their NPL stock in a credible, feasible and timely manner. The ECB is guiding banks to include, within their strategy, quantitative targets by portfolio and a detailed implementation plan. The guidance urges banks to put in place appropriate governance and operations structures to deliver effective NPL workouts. This should be done by closely involving the bank's management, setting up dedicated NPL workout units and establishing clear policies linked to NPL workouts.

3. The proposed amendments

The proposed amendments are essentially anchored around a medium-to-long-term ceiling for the NPLs ratio of credit institutions. Credit institutions holding a higher ratio will be required to draw up a concrete reduction plan to bring the levels of non-performing loans below this ceiling. Failure to adhere to this plan will require the institution to shore up its resiliency through the accumulation of an additional capital reserve. Further details on how this strategy will be operationalised in the BR09 are proposed hereunder.

3.1 Proposed NPL ratio ceiling

The NPL ceiling is proposed to be set at 6%. This ceiling was designed to strike a balance between particular traits of the banking industry in Malta, such as the size of the institutions, their structural characteristics, as well as their operational constraints and the ratios observed in other European countries (excluding the distressed economies). It is also worth noting that the overall NPLs ratio in the EU is biased upwards by the rates of distressed countries that were severely affected by the financial crisis. The current level of economic activity in these countries is therefore not comparable to that of Malta, which in turn has been consistently experiencing high growth rates and has not been affected to the same extent by crisis.

3.2 Conceptual model of the proposed amendments

Figure 1:

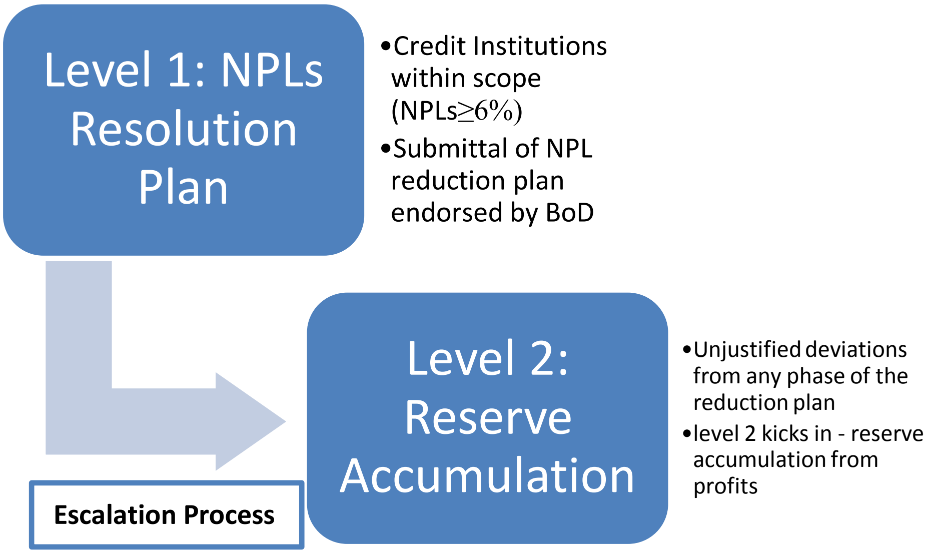

Figure 1. shows a conceptual model of the proposed amendments, which essentially gradate on two levels. These are explained in some more detail as follows.

3.3 Level 1: Non-performing Loans Resolution Plan

The proposed strategy for decreasing NPLs creates a set-up for banks to resolve their problem loans according to a reduction plan. The maximum threshold for NPLs is being set at 6%. The MFSA will communicate directly with the credit institutions which will be deemed to fall within the scope of the said new draft provisions within BR/09.

It is being proposed that credit institutions falling within scope, would be required to submit a multi-year NPL reduction plan not exceeding 5 years. This plan will be required to be endorsed by the institution's Board of Directors and will be reviewed by the MFSA in consultation with the CBM.

The NPL reduction plan will also include annual milestones linked to tangible Key Performance Indicators (KPIs), such as:

- A multi year plan (not exceeding 5 years) showing clearly when the target 6% threshold is to be reached, including the motivation/main drivers of the timeline chosen;
- yearly target NPL ratios;
- yearly target ‘cure’ rates;
- specific details of the loans to be targeted and details about the reduction instrument to be used; and
- disclosure of any forbearance to the current stock of NPLs in view of the reduction plan.

In addition, it is also being proposed that credit institutions will report control variables, on a six monthly basis, following the submission of the NPLs resolution plan. These will include:

- actual NPL level;
- actual ‘cure’ rate;
- actual new NPLs;
- divergences from the Credit Risk Management Framework; and
- information on any forbearance to the NPL stock.

The Credit Institution shall also be requested to conduct a yearly self-assessment (from the date of submission of the NPL reduction plan) of its performance against the set milestones within the reduction plan.

3.4 Level 2: Reserve for Excessive NPLs

In the case where a credit institution, following an annual review by the MFSA, is found to be deviating from any phase of the NPL Reduction Plan, it will be required to allocate capital to a new reserve – ‘Reserve for Excessive NPLs’. The duration of this appropriation will run annually until the NPL reduction plan is back on track and is to be effected from the profits for each corresponding financial year.

However where a credit institution has a high level of Common Equity Tier 1 capital (CET 1) as determined by the Authority, only half (50%) of the appropriation shall be allocated to the Reserve for Excessive NPLs from the profits for the year.

The BR09 amendments feature a scheme by which banks are required to allocate capital to the new reserve at Level 2. As shown in Table 1 hereunder, the allocation of the reserve shall be equivalent to a percentage of the net non-performing loans portfolio of each credit institution falling within scope. The applicable rates are also gradated by the level of the NPLs stock, with higher levels carrying higher allocation rates (Buckets 1 to 3).

Table 1: Reserve Allocation Scheme

	% of NPLs Past due by less than and equal to 12 months	**% of NPLs Past due by more than 12 months**
Bucket 3 (>15%)	3.5%	7%
Bucket 2 (NPL 8% - 15%)	2.25%	4.5%
Bucket 1 (NPL 6% - 8%)	1.5%	3%

The overall applicable allocation rate is therefore the weighted average rate between NPLs being past due by less than and equal to 12 months and those being due by more than 12 months respectively, and charged on the NPLs stock net of provisions and the Reserve for General Banking Risks.

4. Reserve for General Banking Risks

The current allocation of funds to the reserve for general banking risks (BR/09 articles 37 to 44) will be maintained. All credit institutions will have accumulated the required 2.5% for the Reserve for general banking risks by 2016. The transitory provisions will be removed as they are no longer applicable.

5. Coming into Force

The amendments to this Rule shall be applicable upon publication.

6. Contacts

Interested parties are to send their comments in writing by not later than Friday 21st October 2016.

Any comments and feedback are to be addressed to Alexandra Filletti, Senior Manager, Regulatory Development Unit on afilletti@mfsa.com.mt. The Authority reserves the right to disregard any responses sent after the said date.

Communications Unit
Malta Financial Services Authority
MFSA Ref: 11-2016
30th September 2016