MFSA

MALTA FINANCIAL SERVICES AUTHORITY

FEEDBACK STATEMENT ISSUED FURTHER TO THE CONSULTATION ON THE IMPLEMENTATION OF THREE NEW BANKING RULES ISSUED UNDER THE DEPOSITOR COMPENSATION SCHEME REGULATIONS, S.L. 371.09.

[MFSA REF: 10-2016]

16th November 2016

1. Background

On the 16th September 2016, the MFSA issued a Consultation Document on three new Depositor Compensation Scheme ("DCS") Banking Rules: BR17, BR18 and BR19, for a two week consultation period. These were a result of the new DCS Regulations, Subsidiary Legislation 371.09, transposing the Recast Directive 2014/49/EU on Deposit Guarantee Schemes ("DGS")

The Recast Directive introduced a new method of calculating contributions, based on the 'riskiness' of each member. The Directive also established the amount of payment commitments allowed by each member in a given year.

The Management Expenses Banking Rule BR/17 is introduced in terms of the DCS Regulations (S.L 371.09) regulation 26(3). Banking Rule BR/18 is based on the EBA Guidelines on Methods for Calculating Contributions to deposit guarantee schemes, EBL/GL/2015/10 whilst Banking Rule BR/19 is based on EBA Guidelines on Payment Commitments under Directive 2014/49/EU on deposit guarantee schemes, EBA/GL/2015/09.

Below please find an outline on the main comments received in relation to the proposed banking rules and the MFSA's position in relation thereto.

2. Main Comments received on the three banking rules

2.1: BR/17 – Banking Rule on "Management Expenses Contribution" under the Depositor Compensation Scheme Regulations (Sl.371.09)

Industry comment: A respondent sought clarification of their understanding on the estimation of this contribution where each year, the Scheme shall analyse what may be covered via the Schemes reserves, and if there is a shortfall then the banks shall contribute during the following year. The respondent is envisaging that the banks shall not be in a position to account for this shortfall amount in their P&L in the following year within which the shortfall shall need to be expensed and paid.

MFSA's Position: Prior to the expiry of a financial year (year of assessment), the Scheme shall prepare a statement of its estimated revenue and expenses in respect of that year. Subsequently, the Management Committee will decide whether any of the Scheme's reserves will be allocated to the management expenses fund. Where no shortfall in the fund would be envisaged for the year of assessment, no management expenses contribution will be levied and the Scheme will inform each member accordingly before the end of the year of assessment concerned.

In the case of a shortfall in the management expenses fund, the Scheme will levy a management expenses contribution, which will be apportioned between members on the basis of aggregate covered deposits of each member as at 31 December of the year of assessment. As soon as the amount of management expenses contribution due by each bank is determined, the Scheme will notify each member of the amount of contribution due by that member and will provide each member with a copy of the above-mentioned statement. The Scheme will send such notification as soon as possible during the first quarter of the year following the year of assessment.

2.2: BR/18 – Banking Rule on the "Risk-Based Method" and the "Compensation Contribution Method' under the Depositor Compensation Scheme Regulations (Sl.371.09)

Industry comment: A respondent sought clarification over the formula of calculating the Individual Risk Score (IRS) in Annex 2 of BR/18. They noticed that this formula would output a negative result whenever the risk indicator falls between the upper and lower boundaries. The actual question is as follows:

"As per Annex 2, the formula for the IRS if the risk indicator falls between the upper and the lower boundary is A-a (A being the risk indicator and 'a' being the upper boundary); divided by a-b (b being the lower boundary). If say, our NPL ratio is 6%, which falls between the upper and lower boundaries, the numerator of the formula would be 6% -10%. Wouldn't this give a negative result?

MFSA's Position: The comment rightly points to an inadvertent error in the equation in Annex 2, where the numerator in the formula needs to be changed from *A- a* (*'A'* being the risk indicator and *'a'* being the upper boundary) to *A-b* (where *'b'* is the lower boundary). Therefore the first formula in Annex 2 is amended as follows:

$$IRS_j = \frac{A_j - b_j}{a_j - b_j} \times 100\%$$

This formula now completely reflects the formula presented in the EBA Guidelines on Methods for Calculating Contributions to deposit guarantee schemes, EBL/GL/2015/10. Note also that the second formula in Annex 2 is left unchanged.

Industry Comment: One respondent argued that the calibration of the capital, liquidity and leverage risk indicators produced too little differentiation between banks' risk score since these indicators are only aligned to regulatory minimum requirements. While they agree that it makes sense to assign a score of 100 in the case of banks being below the regulatory minimum, there is no argument to assign the same score of 0 to a bank that has its indicator slightly above the regulatory minimum when compared to another bank that has a fairly high ratio to the regulatory minimum. If all banks follow these regulatory requirements, which they should, then these three indicators, which have a total weighting of 48%, will be irrelevant in most cases.

MFSA's Position: We recognise the underlying logic to this feedback, and as a response we have decided to amend the calibration of the Individual Risk Score (IRS) of the first three indicators: the CET1 ratio, Leverage Ratio and the Liquidity Coverage Ratio (LCR).

In order to follow the same sliding scale methodology as the other four indicators, it was necessary to establish an upper boundary for each of the three indicators. We agree with the argument that it is unfair to give the same IRS to a bank that has indicator values very close to the regulatory minimum as well as to others that have their values well above the regulatory minimum, but it is also important to note that having an upper boundary that is too high might negatively impact the risk score of the members. We therefore tried to find common ground between the two and as a result, have

established upper boundaries that are not much greater than the regulatory minimum but are large enough in order to give merit to those banks that have indicator values above the regulatory minimum.

As a result we have decided to add 3 upper boundaries as can be seen below. Note that for any indicator value that lies between the two boundaries, a sliding scale approach will be adopted, similar to the other indicators. An IRS of 100 is still given whenever the value is below the lower boundary and an IRS of 0 whenever the value is above the upper boundary:

a) As regards the CET1 ratio we have kept the 7% regulatory minimum as a lower boundary but have now included 14% as an upper boundary. Our choice of such a boundary reflects data obtained from the EBA's publication "EBA Risk Dashboard Data at Q 2016", where the CET1 for most banks centres around that value.
b) As regards the Leverage ratio, we have included an upper boundary of 4% which is a 30% increase from our lower boundary of 3%. This small buffer zone would, as explained above, give merit to those banks that have indicator values way above the regulatory minimum compared to those that are relatively close to the regulatory minimum.
c) For the LCR, we have decided to include an upper boundary with a 20 percentage point (pp) increase. Recall also that, the lower boundary is changed from 60% in the year of assessment of 2016, to 70% in year of assessment 2017, 80% in 2018 and 100% in 2019. Therefore the upper boundary also needs to be adjusted every year by adding 20pp to the regulatory minimum each year. The new revised full risk indicator boundaries for the year of assessment 2016 can be seen in the table below:

Risk Indicators	Upper Boundary (aj)	Lower Boundary (bj)
CET1 Ratio	14%	7%
Leverage Ratio	4%	3%
LCR [1]	80%	60%
NPL ratio	10%	5%
RWA/ Total Assets	60%	35%
RoA	1.5%	0%
Unencumbered Assets / Covered Deposits	200%	100%

[1] For the year of assessment 2017 the upper and lower boundaries are changed to 90% and 70% respectively, for 2018 the boundaries are changed to 100% and 80%, and finally for 2019 the boundaries are changed to 120% and 100%.

2.3: BR/19 – Banking Rule on Payment Commitment under the Depositor Compensation Scheme Regulations (Sl.371.09)

Industry comment:* *__Appendix 2__ this agreement presumes that the Bank would also have entered into an agreement with the Malta Stock Exchange and the only possible custodian under this type of arrangement is the MSE. Do we have a template of the agreement being proposed by MSE as well as a clear indication of the relevant costs? Also, MSE would have to be licensed by the MFSA for this purpose, so there should be a representation from MFSA that it has all licenses and authorisations required in terms of law:

MFSA's position: The relationship between the bank and the MSE is regulated by the custodian agreement which is entered into between the parties. It is understood that any costs arising from this agreement would also be agreed between the bank and the MSE. In reply to the comment regarding licensing of the MSE, it is to be noted that pursuant to Article 24 of the Financial Markets Act (Cap. 345 of the Laws of Malta), the MSE holds an authorisation from the MFSA to provide the services of a central securities depository, in terms of which it performs, amongst others, custody services

__Industry comment: Page 19, Clause 11:__ The Bank should not pay all fees incurred by the custodian as mentioned in the clause. It is understood that these should be factored into the custodian's fees. The Bank would not have control over the fees incurred by the Custodian and any other charges it may deem fit to include, so it cannot be expected to give a blanket indemnity;

MFSA's Position: The security is required at law to be provided by banks in favour of the Depositor Compensation Scheme (''DCS'') and in case of foreign securities, the aim of the Tripartite Pledge Agreement ensures that the security is being granted in the most efficient manner in the interests of both the banks and the DCS. Per se, any custody fees are to be agreed in advance with the MSE; however in principle, (custodian) fees are to be borne by the pledgor. No changes to this clause are therefore being made.

__Industry comment: Page 22, Clause 28 (a) and (c):__ These obligations should not be triggered ''immediately'' but say ''within X days''. There is also a typo in para (a) – Should be ''provided'' and not ''provides''.

MFSA's Position: The obligations contained in clauses 28(a) and (c) are based on the EBA Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes (the "EBA Guidelines"). These obligations are triggered ''Upon Request'' of the DCS and the DCS would in practice communicate with the bank as to the manner in which this obligation is to be satisfied. No changes to this clause are therefore being effected.

The typo in para (a) is noted and the BR19 is amended accordingly.

__Industry comment: Page 24, Clause 29 (k):__ This should be deleted. When the Pledgor ceases to be a member of the DCS then no further security would be required and therefore, there would be no need to enforce the pledge.

MFSA's Position: No changes to this clause are being undertaken. The cessation of membership is also contemplated in the EBA Guidelines as a further scenario where the DCS can, amongst others, enforce the commitment.

Industry comment: As per BR 19 Appendix 2, if we pledge foreign securities we will be required to enter into a Tripartite Pledge Agreement with the Depositor Compensation Scheme and with the Malta Stock Exchange. Does the MSE have an agreement with foreign custodians such as Clearstream?

MFSA's Position: To pledge foreign securities in favour of the DCS, the bank will need to:

a) enter into a custodian agreement with the Malta Stock Exchange;

b) give instructions for the securities in question to be transferred to the Malta Stock Exchange's account, held with the Clearstream platform, as custodian of the pledgor bank;

c) sign the tri-partite pledge agreement to be entered into between the DCS, the Malta Stock Exchange and the bank.

Appendix 3

Industry comment: Page 38, Clause 15:

At the end of the 2nd paragraph, it is being recommended that the following wording will be added ''to such account as may be indicated to it by the Pledgor from time to time'';

The third paragraph should be amended or deleted because it is too cumbersome that if the account is closed, the moneys are immediately sent to the DCS and applied to reduce the secured obligations. It ought to be kept in mind that this is a payment commitment and not an existing debt of the bank towards the DCS. One alternative could be to transfer them to another account that is already pledged in favour of the DCS.

MFSA's Position: Clause 15 is being reworded as follows:

> *All rights to give instructions to the bank with which the Bank Account is held relating to or connected with payments from the Bank Account, including without limitation payments of interest and repayment of principal and/or any balances, shall vest exclusively in the Pledgee.*
>
> *Unless otherwise instructed by the Pledgee in writing, and prior to the issue of a Notice of Default (as hereinafter defined) by the Pledgee to the Pledgor, payment of interest on the Bank Account shall be made to the Pledgor to such account as may be indicated to the Pledgee by the Pledgor from time to time.*
>
> *Any repayment of principal and/or balances from the Bank Account shall, be credited to account number ______________________in the name of the Pledgee held with the Central Bank of Malta until receipt of further instructions to the Pledgor from the Pledgee regarding these amounts.*

Industry comment: Page 39, Clause 18:

Capital Distributions – Same as above regarding third paragraph of clause 15.

MFSA's Position: This clause is being redrafted as follows:

- Capital Distributions

All capital distributions paid on the Instruments upon redemption of any Instruments shall be credited to account number __________________ in the name of the Pledgee held with the Central Bank of Malta until receipt of further instructions to the Pledgor from the Pledgee regarding these amounts.

Industry comment: Page 41, Clause 23 (a) and (c):

These obligations should not be triggered ''immediately'' but say ''within X days'';

MFSA's Position: Vide the comments above made in respect of clause 28(a) and (c) of Appendix 2.

Clause (f) should be amended so that the obligation within 7 days is to deliver the notice to the bank and not to procure the acknowledgment too. The words ''within a maximum of 7 working days….applicable'' should be moved to just after the words ''Schedule 2 hereto''.

MFSA's Position: No changes are being made to this clause. It is the responsibility of the pledgor to ensure that the pledge is perfected within the shortest timeframe possible, and in any event within this agreed timeframe.

Industry comment: Page 44, Clause 24 (k): This should be deleted. When the Pledgor ceases to be a member of the DCS, then no further security would be required and therefore, there would be no need to enforce the pledge.

MFSA's Position: Vide the comments above made in respect of clause 29(k) of Appendix 2.

Industry comment: Page 54, Undertaking (a): The last sentence of this paragraph, starting ''Any repayment of principal and/or balances..'' should be amended in line with my comments on Clause 15 and clause 18.

MFSA's Position: No changes are required to this clause which can be retained as is even in light of the amendments effected to clauses 15 and 18 above.

Communications Unit
16th November 2016
Ref: 10-2016