

# **MFSA**

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## **MALTA FINANCIAL SERVICES AUTHORITY**

**Basel Core Principles (BCP)**

**International Organisation of Securities Commission (IOSCO)**

**International Association of Insurance Supervisors (IAIS)**

**Independent Assessment**

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## List of Acronyms

1.	AG	Attorney General
2.	AML/CFT	Anti-money laundering/Combating the financing of terrorism
3.	BA	Banking Act
4.	BCBS	Basel Committee for Banking Supervision
5.	BCP	Basel Core Principle
6.	CARD	Consolidated Admission Requirements Directive
7.	CBM	Central Bank of Malta
8.	CDD	Customer Due Diligence (Basle Committee paper)
9.	CDs	Certificates of Deposits
10.	CESR	Committee of European Securities Regulators
11.	CEOPS	Committee of European Insurance and Occupational Pensions Supervisors
12.	CFT	Combating the Financing of Terrorism
13.	CIS	Collective Investment Schemes
14.	CP	Core Principle
15.	CPSIPS	Core Principles for Systemically Important Payment Systems
16.	CPSS	Committee on Payment and Settlement Systems
17.	CA	Companies Act
18.	CC	Commercial Code
19.	CRD	Capital Requirements Directive
20.	CSD	Central Securities Depository
21.	CSS	Central Systems of Securities Settlement
22.	DMO	Debt Management Office
23.	DVP	Delivery Versus Payment
24.	EEA	European Economic Area
25.	Egmont	Egmont Group of Financial Intelligence Units
26.	EU	European Union
27.	EUR	EURO
28.	FATF	Financial Action Task Force on Money Laundering
29.	FIA	Financial Institutions Act
30.	FIAU	Financial Intelligence Analysis Unit
31.	FIU	Financial Intelligence Unit
32.	FSAP	Financial Sector Assessment Program
33.	FT	Financing of Terrorism
34.	IAIS	International Association of Insurance Supervisors
35.	IAS	International Accounting Standards
36.	IBA	Investment Business Act
37.	IBNR	Incurred But Not Reported (Claims)
38.	ICP	Insurance Core Principle
39.	IIA	Insurance Intermediaries Act
40.	IIR	Insurance Intermediation Rule
41.	IMD	EU Directive 2002/92/EC (Directive on Insurance Mediation)
42.	IOPS	International Organisation of Pension Supervisors
43.	IPSU	Insurance and Pensions Supervision Unit
44.	IOSCO	International Organization of Securities Commissions
45.	IPF	Investor Protection Fund
46.	IR	Insurance Rule (No./Year)
47.	ISA	Investment Services Act
48.	KYC	Know Your Customer
49.	Lm	Maltese lire/liri
50.	LN	Legal Notice (No./Year)

51.	LOLR	Lender-of-last-Resort
52.	MaRIS	Malta Real-Time Interbank Settlement System
53.	MFP Code	Code of Good Practices on Transparency in Monetary and Financial Policies
54.	MFSA	Malta Financial Services Authority
55.	ML	Money Laundering
56.	MLAT	Mutual Legal Assistance Treaty
57.	MLRO	Money Laundering Reporting Officer
58.	MiFID	Markets in Financial Instruments Directive
59.	MMofU	Multilateral Memorandum of Understanding
60.	MONEYVA	Council of Europe Sub-Committee on Money Laundering
61.	MofF	Minister of Finance
62.	MOU	Memorandum of Understanding
63.	MSE	Malta Stock Exchange
64.	NCCT	Non-Cooperative Country or Territory
65.	NPL	Non-Performing Loans
66.	ORSA	Own Risk and Solvency Assessment
67.	PCC	Protected Cell Company
68.	PCF	Protection and Compensation Fund
69.	PDAC	Public Debt Advisory Committee
70.	PML	Probable Maximum Loss
71.	PIF	Professional Investor Fund
72.	PMLA	Prevention of Money Laundering Act, 1994 (as amended)
73.	PMLR	Prevention of Money Laundering Regulations, 1994
74.	PSA	Professional Secrecy Act
75.	P&L	Profit and Loss Statement
76.	QROPS	Qualifying Recognised Overseas Pension Scheme
77.	RMICAP	Risk Management and Internal Capital Adequacy Assessment Process
78.	ROA	Return on Assets
79.	ROE	Return on Equity
80.	RTGS	Real Time Gross Settlement System
81.	SR	Special Recommendation (of FATF on terrorist financing)
82.	SRO	Self-Regulatory Organization
83.	STR	Suspicious Transaction Report
84.	SRP	Supervisory Review Process (Solvency II)
85.	SWIFT	Society of Worldwide Interbank Financial Telecommunications
86.	UN	United Nations
87.	UNSCR	United Nations Security Council Resolution

## 1. General Introduction

### 1.1 Introduction

Since its setup in 2002 as the single regulator for financial services, the MFSA has worked to ensure the creation of a reputable financial centre. As part of the initial efforts, the IMF / World Bank were requested in late 2002 and early 2003 to conduct a Financial Sector Assessment Programme (FSAP). **The assessment concluded that Malta's financial system appeared to be healthy and well supervised, with a comprehensive legal framework and strong adherence to most international standards and codes for regulatory and supervisory practices.** EU membership provided a further assessment of the MFSA's regulatory and supervisory regimes prior to accession in 2004 which has proved to be an important catalyst for the further development of the financial services industry.

In order to maintain the highest standards in regulation and supervision, the Board of Governors of the MFSA requested that an internal audit of the MFSA regulatory activities is carried out every two to three years following the IMF/World Bank assessment. Internal audits were carried out in 2005 and 2007. A further internal audit was due to be carried out in 2009, however, because of the number of new legislative changes coming into force at EU level and because of changes in composition of the Supervisory Council, the internal audit was postponed to 2010. The Board noting that increased transparency was being requested from companies following the global financial crises decided that the 2010 internal audit should take the form of an independent assessment and should be carried out using the same format as the FSAP, and this assessment and future assessments should be made public.

Following the publication of the De Larosiere Report <sup>1</sup> recommending increased emphasis on supervision, the EU Commission has moved towards the creation of three European Supervisory Authorities to deal with banking, insurance and pensions, securities and markets supervision. These Authorities will periodically organise and conduct peer review analyses of some or all of the activities of Competent Authorities, to further enhance consistency in supervision across all Member States. It is envisaged that when conducting peer reviews, existing information and evaluations already made with regard to the Competent Authority concerned shall be taken into account by the new Authorities. This independent assessment therefore assumes greater importance for the reputation of the MFSA.

### 1.2 Development of the Malta Financial Services Sector

Over the past 10 years Malta has continued to upgrade and consolidate a comprehensive legislative and regulatory framework for financial services activities as an ongoing process. A number of important factors have influenced the development of the sector during this period.

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<sup>1</sup> De Larosiere: The high-level group on financial supervision in the EU. Report 2009

Also during this period the Central Bank of Malta became a member of the European Central Bank and part of the European System of Central Banks, while the Malta Financial Services Authority (MFSA) became a member of the European Committees of Supervisors (CESR, CEBS and CEIOPS) which will in 2011 become European Supervisory Authorities (EBA, EIOPA and ESMA). Following membership of International Organisation of Securities Commission (IOSCO) in 2002 the MFSA also became a member of the International Association of Insurance Supervisors (IAIS) in 2007. The Authority also signed an MMOU with IOSCO in 2006 and with IAIS in 2011.

The move to the single regulator in 2002 brought the regulation of all financial services activities - including banking, securities, investment and trustee services, insurance and pensions and stock exchange - under the responsibility of the MFSA and **Malta continued to develop a comprehensive and integrated legal framework for the financial services sector through the enactment of new laws as well as the enhancement, amendment and consolidation of existing legislation.**

While the setting up of a strong regulatory and licensing financial services authority operating to the highest standards is central to the legislative programme, Malta's policies also give due importance to the processes of financial innovation and improvements in the organisation of the financial services sector and the availability of competent human resources.

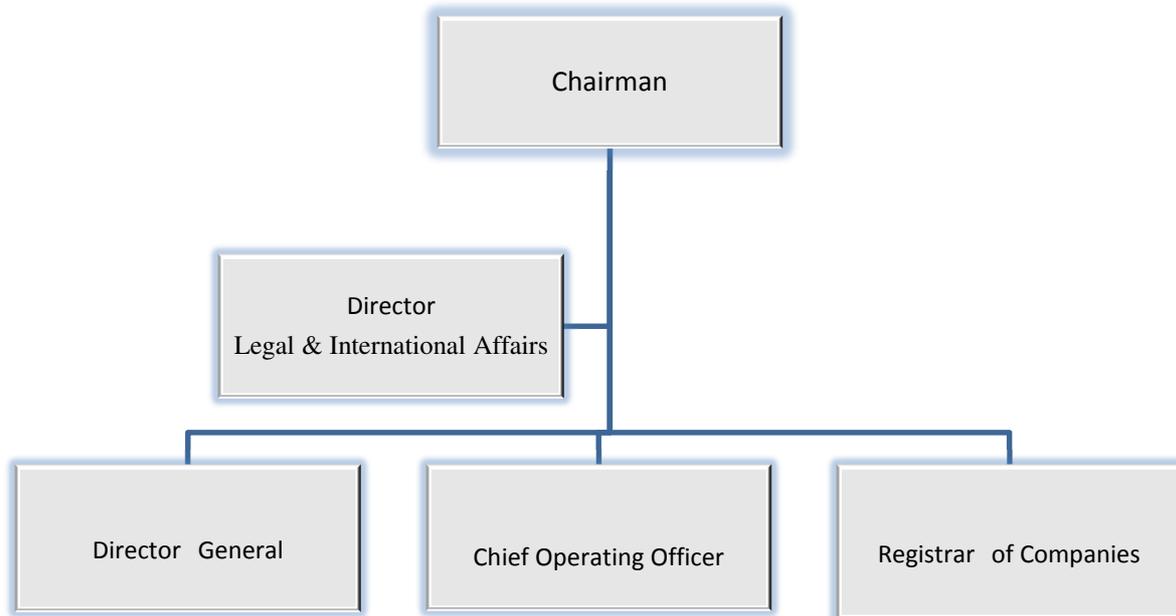
The MFSA continuously monitors market developments in order to ensure that innovation does not out-strip regulation. **These initiatives have ensured that the Authority stays ahead of the market in the development of the regulatory infrastructure, while enabling the market to develop new products and opportunities.**

**The MFSA is headed by a Chairman and a Board of Governors appointed by the Prime Minister that sets policy for the Authority. The Board of Governors is composed of seven members including the Chairman. A Coordination Committee exists to coordinate the application of policies approved by the Board and the Board's relations with the Supervisory Council.** The organizational structure of the MFSA ensures that the regulatory and operational functions of the Authority are exercised within strict legal demarcations. The Board of Governors, presided by the Chairman, sets policy and general direction. The Supervisory Council, headed by the Director General, is exclusively responsible for issuing licences, regulation and supervision and the Board of Management and Resources is responsible for management operations and is headed by the Chief Operations Officer. It is in charge of ensuring the day-to-day management of the Authority as regards, e.g., IT, human resources, and training.

**High-level co-ordination between the heads of these three organs is ensured at Co-ordination Committee level. The Registry of Companies, which is managed by the MFSA, is the fourth member of this Committee.**

## MFSA ORGANISATIONAL STRUCTURE

### Composition of the Co-ordination Committee



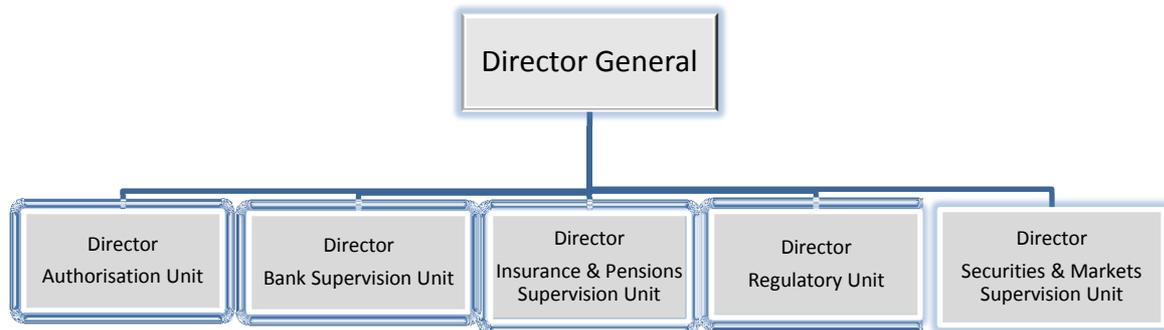
Following the amendments to the MFSA Act in 2002, the Authority also developed a Consumer Affairs Unit independently of the Supervisory Council. This has provided consumers with an additional channel of impartial redress by endeavouring to guide the parties to reach a mediated solution. The Unit is also heavily involved in consumer awareness and education initiatives.

On January 1, 2010 the MFSA adopted a new regulatory framework through changes in the manner in which the regulatory and supervisory functions are carried out within the Supervisory Council which is chaired by the Director General and is **attended as members by the Directors of the Supervisory Units (Banking, Securities, Insurance and Pensions), the Director of the Authorisation Unit, and the Director of the Regulatory Development Unit.**

**The role of this group is more operational and more directly influences banking supervision's on-going activities. Its designated role is to license, monitor and supervise all activities related to financial services.** The primary objective of the reform was to deliver greater supervisory effectiveness and to ensure a better level of integration in the exercise of the regulatory functions. This greater harmonisation is expected to lead to a high level of consistency in functions such as licensing and risk-based supervision and improve co-operation and information-sharing across the Authority.

The new model for the Supervisory Council therefore represents an integrated approach to regulation and supervision being provided through a single Authorisation Unit, specialist Supervision Units, for Banking, Insurance and Occupational Pensions and Securities and Markets, and a Regulatory Development Unit.

### SUPERVISORY COUNCIL



The new Authorisation Unit is responsible for licensing of all financial services entities. The Unit receives and processes all applications for authorisation to conduct regulated financial services business in Malta. The remit of the new Regulatory Development Unit is to coordinate the development of cross-sector policy initiatives and to enable the MFSA to address market and regulatory developments as they arise. The Supervisory Units have a more focused risk-based approach to supervision with retained specialisations in banking, insurance and securities and markets.

### 1.3 The Maltese Financial Services Sector

As the Maltese economy becomes more service oriented, financial services are becoming important to the Malta's economic future. The financial services industry is valuable to Malta. It is therefore in the Malta's long-term and strategic interests to ensure that – subject to effective regulation and supervision – the financial services sector is improved and strengthened in order to maximise its contribution to the Maltese economy.

In terms of GDP, Malta is the 86th largest economy<sup>2</sup>, The financial services industry has grown considerably in recent years although real economy contracted by 2.2% in 2009 - after growing 2,1% in 2008 and 4% in 2007. Of a labour force of 177,532 (6/2010),

<sup>2</sup> All figures taken from Sigma 2/2010 ("World Insurance 2009") and the CIA World Fact book

about 7,000 are employed by insurers, financial intermediaries, and service providers. Another 1500 lawyers, accountants and other persons provide professional and ancillary services to the financial services sector. Despite this development, key figures show that there are still huge opportunities in the market.

**Malta's strengths have been its open market based economy, its regulatory, accounting and legal frameworks, its skilled labour force, its developing mass of financial services participants, as well as the use of English as a business language and the relative long-term stability and predictability of its tax regime.**

The financial services industry is starting to play a vital role in the Maltese economy. The sector is much diversified and includes banking, insurance, asset management operations and a wide array of supporting professional services. The proportion of financial services in Malta is not high to warrant concerns about an “unbalanced” economy. The Gross Value Added (GVA) in the Financial Intermediation sector amounted to around 6 per cent of the total GVA in 2009 from 4.5 per cent in 2008 and 4.3 per cent in 2007. This is similar to the United States and less than Ireland and Luxembourg. The Gross Value Added per employee in the Financial Intermediation sector was around €50,000 per capita.

The industry is responsible for contributing almost 4.3 per cent of all tax collected in 2008, with total income tax collected from companies engaged in financial intermediation estimated to have reached over €100million in 2009 – financing much needed for Government revenue. It also contributes to the balance of payments by exporting services and products. In 2008, Foreign Direct Investment (FDI) flows in Malta in the Financial Intermediation sector amounted to 64 per cent of the total FDI while in 2007 it amounted to 28%.

Financial services also have a number of multiplier effects on the rest of the non-financial economy. This effect is vital to the national economy, for government and public services, for companies – whether international or domestic – and for citizens. Estimates for the total proportion of the economy made up by the financial services industry are difficult to resolve due to the effects of “financial intermediation services indirectly measured”. These include related services such as accountancy, legal and treasury services and the demand generated by the financial services sector for other indirect services, such as IT, telecommunications, publishing, hospitality and other business related. Data on these services is not normally published separately by the National Statistics Office.

The main core areas of the financial sector – banking, insurance, investments - support individuals and businesses by:

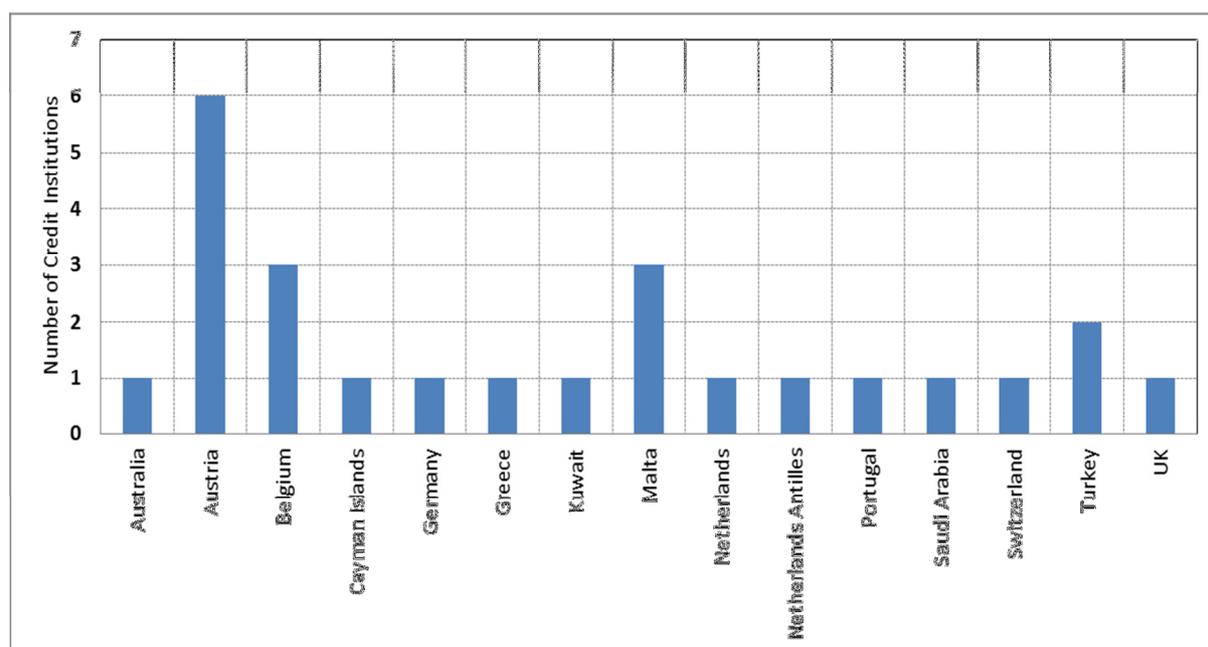
- providing finance for individuals, households, business and government,
- helping businesses and individuals manage their risks effectively, and
- allowing society to accumulate wealth through sensible investments.

Also payment systems and other types of financial services infrastructure such as clearing and settlement provide the mechanisms through which businesses and individuals can carry out transactions quickly and reliably through a global network.

The global financial crisis has had little or no direct effect on the Maltese financial services sector. None of the currently licensed banking institutions suffered a liquidity crisis although they suffered a lower return on their foreign investments which in some cases necessitated a strengthening of their balance sheet through the issue of corporate bonds.

### 1.3.1 Banking Sector

The Maltese banking sector consists of 23 credit institutions authorised to conduct business. Three of these are majority Maltese-owned while 20 are foreign credit institutions having a physical presence in Malta. 13 foreign credit institutions are from EU countries, five from non-EU countries and another two are branches from non-EU countries (Fig 1.1).

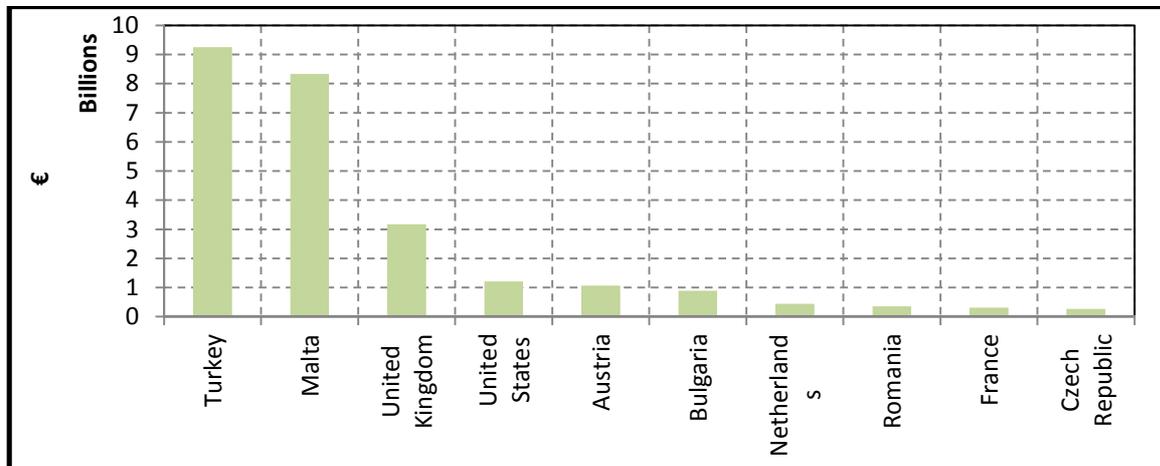


**Figure 1.1: Number of Credit Institutions by Country of Origin of Major Shareholder**

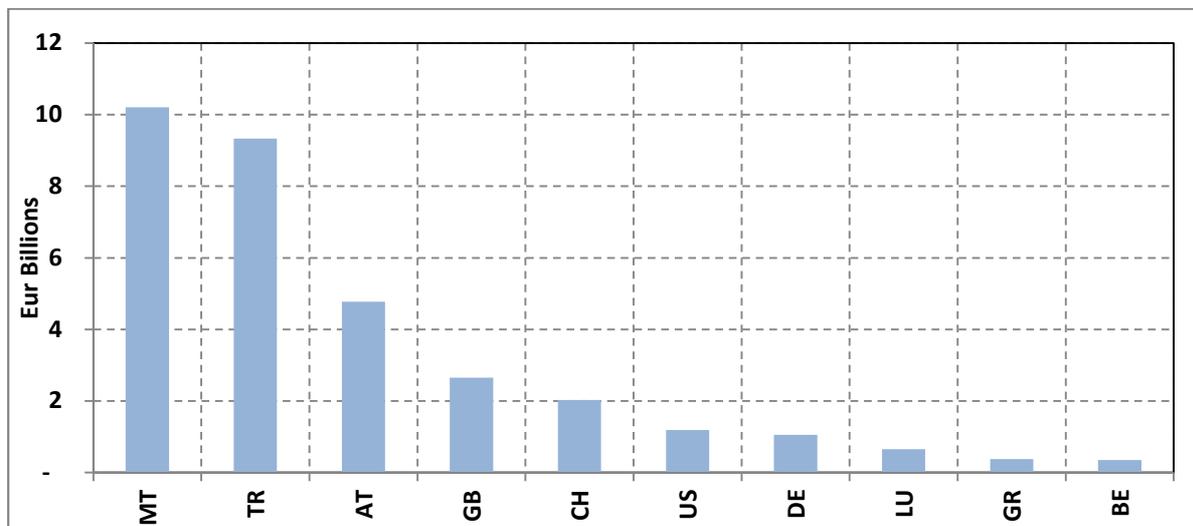
At the start of the financial crisis in 2007, global banking operations experienced significant contractions in their balance sheets, however, the Maltese banking sector remained resilient due particularly to the strong capital base and liquidity of Maltese banks which continued to enjoy strong positive deposit to loan ratios. The banking system was reported to be the 13th soundest in the world by The World Economic Forum’s Global Competitiveness Index 2009-2010.

The prevalence of the traditional banking model in Malta, where banks fund their lending activities mainly from deposit taking, became more pronounced in 2008 and 2009 as it became increasingly difficult to tap liquidity from the international markets. It is clear that this model has paid dividends during the crisis. An analysis on the level of international

lending and borrowing for 2009 by the banks licensed in Malta is illustrated in Figs 1.2 and 1.3 respectively.



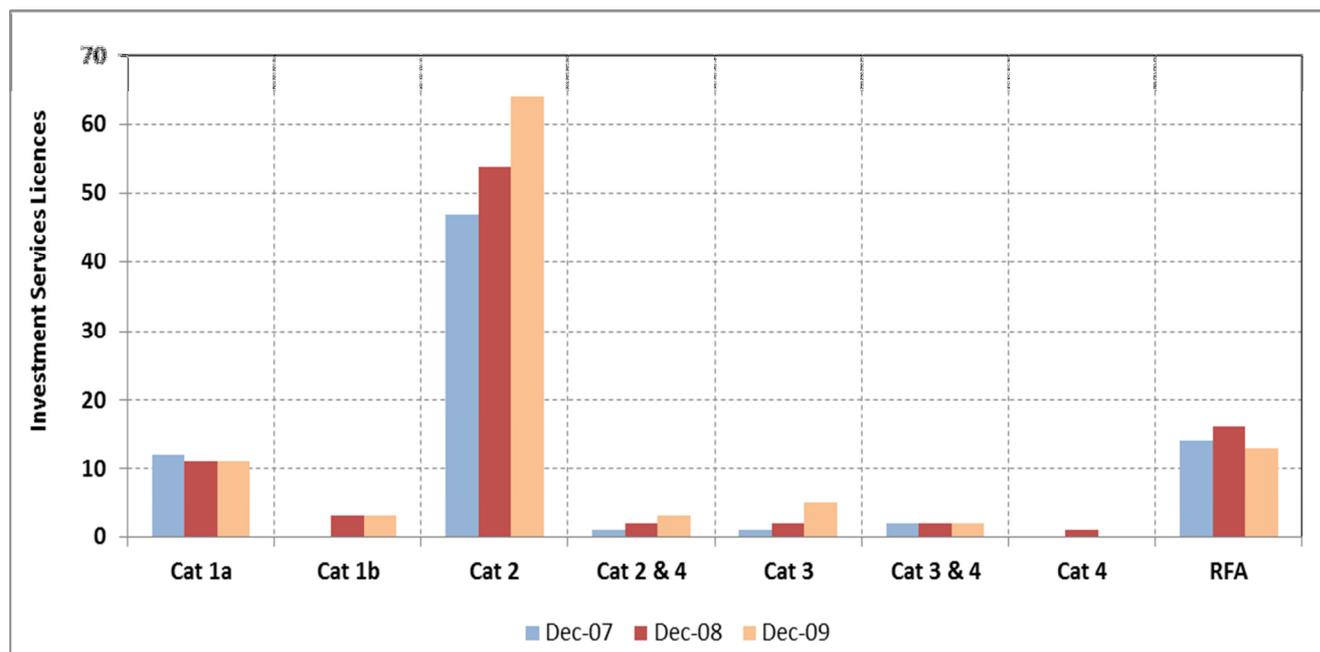
**Figure 1.2: International Lending and Borrowing: Top Ten Countries by Assets**



**Figure 1.3: International Lending and Borrowing: Top Ten Countries by Liabilities**

### 1.3.2 Investment Services Sector

The investment services sector continued to consolidate and expand with the establishment of more international providers. As at the end 2009, there were 88 investment services licence holders, an increase of 40% in the period 2007 – 2009. During this period, the number of authorized Category 2 investment services increased from 47 to 64 (Fig 1.4). Also other investment services companies had their licence extended to provide additional services



**Figure 1.4 Investment Services Companies licensed during the Period 2007-2009**

The number of newly licensed Collective Investment Schemes continued to increase overall although there was a slight decrease in the total number of licences in 2009. This was mainly due to secondary registered retail funds no longer being sold on the Maltese market. At the end of 2009, the total number of funds (including sub-funds) was 392 with the majority of the licences targeting Professional Investor Funds.

The aggregate Net Asset Value (NAV) of Malta domiciled investment funds (PIFs, UCITS, and Non-UCITS) as at end of 2009 registered €7 billion. This represents a slight increase over the previous year. This increase in the NAV was due to a number of new funds starting operations during 2009 and a range of funds which started slowly recovering from the financial crises. Furthermore, a number of non-domiciled funds are also being serviced by Malta based fund and administration companies. The Net Asset Value (NAV) of these funds as at December 2009 amounted to around €0.8 billion.

Malta has the necessary infrastructure in place for the continued expansion of the investment services sector. Accountants are trained under IFRS, which Malta adopted in 1998. The World Economic Forum Report on Competitiveness (2009) places Malta 8<sup>th</sup> in the world

regarding the strength of auditing and reporting standards. The challenge for the sector is to have sufficiently trained lawyers, accountants, investment managers, fund managers, fund administrators etc.

### 1.3.3 Insurance Sector

Malta has a developed insurance market (world rank 60<sup>3</sup>). In terms of insurance density Malta holds rank 33 world-wide with premiums per capita<sup>4</sup> of € 657 (Life: € 430, Non-life: € 227), and rank 34 regarding market penetration with an overall rate of 4.7 (Life: 3.1, Non-life: 1.6). While these figures prove that Malta hosts an already developed insurance market, a comparison with some other regions and countries (Europe Top 10 average/Italy/France) suggests there is still room for growth. The Europe Top 10 average in terms of insurance density was € 3,706 in 2009, France stood at € 3,063 and Italy at € 1,958). The overall penetration of the EU Top 10 was 9.8% (Life: 6.56, Non-life: 3.22), France stood at 10.3 (7.2/3.1) and Italy at 7.8 (5.3/2.4)<sup>5</sup>.

Shortly after EU accession in 2004, there were 8 local insurers servicing the local market. By 30 June, 2010, 34 companies were authorised to carry out insurance business, plus 8 affiliated insurers and 3 Protected Cell Companies (Table 1.1).

**Table 1.1: Authorised insurance undertakings in a timeline, 2004 – 2010**

	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008	Dec 2009	June 2010
<b>Local Insurers:</b>							
Direct Insurers and Reinsurers	8	12	17	24	32	34	35
Affiliated Insurers	0	4	5	5	6	8	8
Protected Cell Companies	0	0	1	1	3	3	3
<b>Foreign Insurers<sup>6</sup></b>	12	10	3	3	2	2	2

<sup>3</sup> in terms of premium

<sup>4</sup> excluding cross-border business

<sup>5</sup> Some of these figures taken from the Sigma report are provisional or estimated.

<sup>6</sup> Insurers with its Head Office outside the EU/EEA which hold an authorisation to carry on insurance business in Malta

The section showing local insurers comprises 31 non-life insurers, 8 life insurers, 3 composites and 4 reinsurers. In addition, a number of EU/EEA insurers offer insurance services via the right of establishment (6 insurance companies) or the freedom to provide services (357 insurance and reinsurance companies).

Insurance intermediaries are registered by the MFSA, or enrolled, if they are companies or tied intermediaries. At the end of 2009, 13 insurance managers, 16 agents and 28 brokers were enrolled. Registered were 664 individuals, 23 of them being insurance managers, 28 agents, and 69 brokers. Besides, a vast number of agents and brokers from other EU/EEA Member States offers insurance services into Malta, mainly by freedom of services.

Table 1.2 shows how the insurance markets in Malta and Europe as a whole have become interdependent. 65.2% of shareholdings are in possession of EU-domiciled entities.

**Table 1.2: Ownership of insurance companies**

Maltese shareholding	21,7%
EU shareholding	65,2%
Non-EU shareholding	13,1%

Over the last 5 years, the market proved that it was able to provide satisfactory returns in total (Table 1.3), showing quite impressive results for some years in each subsector (except composites, which can be considered a negative outlier and stressed the overall 2009 returns).

**Table 1.3: Return on equity of insurance undertakings in Malta (in %)**

	2005	2006	2007	2008	2009
Long term business	9.40	13.60	8.58	6.10	8.31
General business	18.60	6.40	18.77	11.55	5.57
Composites	-	2.60	6.12	-6.42	-80.40
Reinsurers	-	5.10	17.85	17.80	7.27
Total	15.70	8.0	14.86	10.01	0.73

Capital adequacy ratios (Table 1.4) have maintained more than comforting levels in the last years. During the financial crisis, rates have fallen quite noticeably, but are still maintaining very sufficient levels overall.

**Table 1.4: Solvency cover 2007 – 2010 in %**

Solvency Cover	2007	2008	2009	2.Q. 2010
Long-term	228	242	196	188
General	460	341	322	366
Reinsurers	501	772	498	334
Total	362	348	308	304

The pension sector itself as well as compliance to the IOPS Principles of Private Pension Supervision did not fall within the scope of the audit. Due to the rather small size of the sector, it was decided to not extend the scope of the assessment. Thus, some comments shall suffice. Encouraging steps have been taken to vitalize the pension business in Malta. At the time of the audit, four retirement schemes, four retirement scheme administrators, and three body corporates were authorised to carry out operations in Malta. The UK Revenue & Customs authority recognized Malta as a jurisdiction to which UK pensions could be transferred at the end of November. QROPS recognition allows persons who are no longer resident in the UK to transfer pension benefits accumulated in a UK Recognised Pension Scheme to a recognized pension scheme situated outside the UK. The Special Funds (Regulation) Act of 2002, along with regulations (on subjects like registration of custodians, control of assets, registration fees etc.) and pensions directives (Standard Operational Conditions, guidance, forms etc.), provides a legal framework, but will be replaced by the Retirement Pensions Act soon. The new law is bound to offer more flexible arrangements and to attract multinational companies that may want to use Malta as a centre for their pensions-related operations. as a basis for the future development of the sector.

## **2. COMPLIANCE OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

### **2.1 Introduction**

An independent assessment to update the 2002/2003 FSAP evaluation was conducted during July 27-31 and September 6-7, 2010 by Piero Ugolini (former Assistant Director – IMF and Mission Chief of the IMF/World Bank team that conducted the 2002/3 FSAP exercise) and Richard Nun (former Deputy Director – Texas Banking/Finance Commission, Austin-Texas; and currently peripatetic expert in banking Supervision – IMF and Centennial Group – Washington D.C).

### **2.2 The Banking Supervision Unit**

The Banking Supervision Unit (BSU) carries out banking regulation and compliance, onsite and offsite supervision and methodology. BSU is guided by goals and objectives of the MFSA Act as enumerated in an internal procedures document. BSU has adopted a “risk-based” approach which integrates each of the pertinent supervisory functions into the oversight activity. Suggestions for fine-tuning the supervisory policy, approach, and bank strategies are provided in various areas of the independent assessment report.

Resources allocated to the BSU ensure that personnel are provided with technical training through attendance at seminars and conferences both locally and overseas. BSU personnel participate in EU and the Committee of European banking Supervisors (CEBS) working groups either remotely or through attendance at meetings of particular working groups where necessary. However, senior officials attend all meetings of colleges of supervisors.

As indicated in the introduction, the size of the financial sector, including international banks, has grown in recent years. The offshore regime was eliminated in 1994 and phased out in 2004.

### **2.3 Principle-by-Principle Assessment**

The assessment of the CPs is based on a five-part assessment system: *compliant, largely compliant, materially non-compliant, non-compliant, and non-applicable*. A principle is considered *compliant* whenever all essential criteria are generally met without any significant deficiencies. A principle is considered *largely compliant* whenever only minor shortcomings are observed, which do not raise any concerns about the authority’s ability and intent to achieve full compliance with the principle within a prescribed period of time. A principle will be considered *materially non-compliant* whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A principle will be considered *non-compliant* whenever no substantive progress toward compliance has been achieved. A principle will be considered *non-applicable* whenever, in the view of the assessor, the CP does not apply given the structural, legal and institutional features of a country.

## 2.4 Main Findings of the 2010 Independent Assessment

Considerable progress has been made by the MFSA after taking over the responsibility of supervising the banking sector from the Central Bank of Malta in January 2002. Subsequently, the entry into the EU in 2004 has had the main impact of introducing in the Malta financial sector all the EU Directives aimed at strengthening and ameliorating the soundness of the banking sector. As a result of these relevant changes, this audit has found a significant improvement in the overall compliance to the BCPs.

As shown in the Table 2.1 below, this independent assessment concludes that the MFSA is **Compliant** with twenty Principles and **Largely Compliant** with the five remaining Principles; there are no instances where the MFSA is **Materially Non-Compliant** or **Non-Compliant**. This compares favorably with the 2002/2003 FSAP where the MFSA was **Compliant** with eleven Principles, **Largely Compliant** with twelve Principles, and **Materially Non-Compliant** with one Principle.

**Table 2.1 COMPARISON of COMPLIANCE – 2002/3 FSAP vs. 2010 Independent Assessment**

Core Principle		Assessment <sup>1</sup>	
		2003	2010
1	Objectives, independence, powers, transparency and cooperation		
1.1	Responsibilities and objectives	C	C
1.2	Independence, accountability and transparency	LC	LC
1.3	Legal framework	C	C
1.4	Legal powers	LC	C
1.5	Legal protection	C	C
1.6	Cooperation	LC	C
2	Permissible activities	C	C
3	Licensing criteria	C	C
4	Transfer of significant ownership	C	C
5	Major acquisitions	C	C
6	Capital adequacy	LC	C
7	Risk management process	NA <sup>2</sup>	C

8	Credit risk	C	C
9	Problem assets, provisions and reserves	LC	C
10	Large exposure limits	C	C
11	Exposures to related parties	LC	LC
12	Country and transfer risks	C	C
13	Market risks	LC	C
14	Liquidity risk	LC	C
15	Operational risk	NA <sup>3</sup>	C
16	Interest rate risk	NA <sup>3</sup>	C
17	Internal control and audit	LC	C
18	Abuse of financial services	LC	C
19	Supervisory approach	LC	LC
20	Supervisory techniques	LC	LC
21	Supervisory reporting	LC	C
22	Accounting and disclosure	C	C
23	Corrective and remedial powers	MNC	LC
24	Consolidated supervision	C	C
25	Home-host relationships	LC	C

<sup>1</sup> C-Compliant; LC-Largely compliant; MNC-Materially non-compliant; NC-non-compliant; NA-not applicable. Upgraded assessments are shaded in green.

<sup>2</sup> Not shown as separate CP in 2003; added in 2006 revision of BCPs.

<sup>3</sup> **Previously included as part of CP 13, Other risks; added as separate CP in 2006**

## **2.5 Update 2010 Independent Assessment Summary Compliance with the Basel Core Principles – ROSCs**

Hereunder are the assessors' comments regarding improvements registered in relation to those Core Principles which were rated as *Largely Compliant/Materially Non-Compliant* by the IMF team in their 2002/2003 Assessment, which, except for Principles 1(2), 11, 19,20 and 23 have now been upgraded to *Compliant* as a result.

<b>Principle 1(2).</b>	<b>Independence, accountability and transparency 2002/03 FSAP - Largely Compliant; 2010 Independent Assessment – Largely Compliant</b>
	<p><i>Essential Criteria:</i> A circular issued by the Office of the Prime Minister (OPM) -OPM No 14/2005 of April 25, 2005 has introduced a process for recruitment in the Public Sector Organizations. Under this process, recruitment in the MFSA has to follow these procedures. The intent of the OPM circular was to “ensure a more efficient and effective Public Service and Public Sector”.</p> <p><i>Additional Criteria:</i> While resources to date have been generally adequate for the scale and scope of MFSA's supervisory functions, new regulatory requirements and obligations resulting from coming changes in EU legislative frameworks will have various implications for staffing. This, along with the need to increase the frequency and scope of on-site examinations, particularly through SREPs, will require additional staff. However, the 2005 OPM Circular has delayed considerably the time required for recruiting staff in the MFSA. As a result of the cumbersome process and administrative layers under which the MFSA has to operate, the recruitment process could take several months and impact on the workload of the MFSA staff. The process should be streamlined and shortened.</p> <p>Regarding training, staff will attend seminars offered by amongst others, the Deutsche Bundesbank, the BIS, the FSA, the Committee of European Banking Supervisors, and its respective working groups.</p> <p>The MFSA Act is being amended to require that the MoF will appoint the MFSA as the Competent Authority for banking supervision. The authorities also are giving consideration to public disclosure of the reasons for dismissal in the event that the head of the authority is dismissed. Regarding penalties, Legal Notice 155 was amended in 2007. While the penalty amounts specified in law may appear low, they conform to local standards and, in the context of Malta, the quantum of a penalty is less important as a deterrent than public disclosure. Since 2004, the MFSA publishes penalties and sanctions on its website (i.e. name-and-shame), and future removal from the website is linked to the severity of the misconduct that gave rise to the penalty or sanction.</p> <p><u>Enacting the amendment regarding the appointment of MFSA as the competent authority for banking supervision and publicly disclosing the reasons for dismissals as indicated above; and shortening the recruitment process of MFSA staff would avail upgrading this principle to Compliant.</u></p>
<b>Principle 1(4).</b>	<b>Legal Powers 2002/03 FSAP - Largely Compliant; 2010 Independent Assessment - Compliant</b>
	<p><i>Essential Criteria:</i> Provisions in the BA, which are based on EU Directives, allow MFSA to impose corrective measures on licensed institutions; however, the BA does not explicitly refer to a prompt corrective action framework because such framework is not envisaged in EU Directives.</p>

	<p>Article 9(2, 3) of the BA authorizes MFSA to apply corrective and remedial measures. In addition, the MFSA has adopted, within the context of the Pillar 2 framework which covers all banking risks, prudential measures as part of Banking Rule BR/12; the first such measure states "...prudential measures to address issues identified either through the SREP or as part of on-going supervision, should be applied promptly."</p> <p>Finally, the MFSA, under the Capital Requirements Directive (CRD), has authority to take appropriate prudential measures pursuant to Pillar II of the Supervisory Review and Evaluation Process (SREP) on banks where the results of an Internal Capital Adequacy Assessment Process (ICAAP) are less than satisfactory.</p> <p>The maximum penalty, applicable upon breach of BA Art. 35 (1), concealment of material facts and statement of misleading information, is not less than €232.94 (Lm100) or more than €1,164,686.70 (Lm 500,000). Prison term cannot exceed two years.</p> <p>Other examples of monetary fines include:  € 232.94 (Lm100) per day for: "failure of own funds of bank to attain prescribed level within period determined by the (supervisor)"  € 23.29 (Lm10) per day for: "failure to furnish information or documents as required by the (supervisor) within the specified time"  € 11,646.87 (Lm5,000) for: "failure to appoint an auditor"  € 58.23 (Lm25) per day for: "failure to forward to (supervisor) and/or Central Bank, or to publish, or to exhibit a copy of financial statements".</p> <p>The penalty amounts specified in law may appear low; however, they conform to local standards. Moreover, in the context of Malta, the amount of a fine is less of a deterrent than public disclosure. Since 2004, the MFSA publishes penalties and sanctions on its website (i.e. "name-and-shame"), and future removal from the website is linked to the severity of the misconduct that gave rise to the penalty or sanction. It is still recommended, however, that the issue of monetary fines be re-visited with the two-fold aim of (i) more explicitly defining the circumstances when fines will be applied and (ii) more closely linking the amounts of fines to the severity of the infraction.</p> <p><b>Additional Criteria:</b> None.</p>
<b>Principle 1(6).</b>	<p><b>Cooperation</b>  <b>2002/03 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b></p>
	<p><b>Essential Criteria:</b> The MFSA has concluded several bilateral Memoranda of Understanding (MOUs) with foreign financial services regulators and is a signatory to specialized multilateral MOUs.</p> <p>The following Memoranda of Understanding are now in effect:</p> <ul style="list-style-type: none"> <li>Bilateral MOUs with Foreign Regulators – 24</li> <li>Letter Agreements with Foreign Regulators – 2</li> <li>Multilateral MOUs and Protocols – 9</li> <li>Bilateral MOUs with Local Authorities – 3.</li> </ul> <p>(A detailed listing of individual agreements is available on the MFSA web-site).</p> <p>In addition to formalizing the information-sharing process through bilateral and multi-lateral agreements, cooperation among regulators has been enhanced by colleges of supervisors whose role has gained increasing importance in the aftermath of the global financial crisis. Art. 25A of the BA, adopted in 2007, specifically requires the MFSA to cooperate closely with overseas regulatory authorities on a consolidated basis, and</p>

	<p>MFSA is doing so on both a formal and informal basis particularly for implementation of the Capital Requirements Directive (CRD).</p> <p><i>Additional Criteria:</i> None.</p>
<b>Principle 6.</b>	<p><b>Capital adequacy</b>  <b>2002/3FSAP - Largely Compliant; 2010 Independent Assessment – Compliant</b></p>
	<p><i>Essential Criteria:</i> Since 2006, the capital adequacy framework has been upgraded in line with the relevant EU initiatives. The current framework (BR/04 and BR/08) implements the Basel II Framework for Pillar I capital requirements.</p> <p>In respect of Pillar II requirements of the Basel II framework, Art. 17B of the BA requires a credit institution to establish robust governance arrangements, Art. 17C requires credit institutions to establish an ICAAP and Art. 17D requires MFSA to conduct SREPs over licensed credit institutions. The aim of these provisions is to ensure that credit institutions have sufficient capital to support all material risks, including Pillar II risks.</p> <p>BA Art. 16A(2) requires that a specific own funds requirement in excess of the minimum level laid down in the above mentioned sub-article shall be imposed by the competent authority at least on credit institutions which do not meet the requirements laid down in a Banking Rule and in Art. 17B of this Act, or in respect of which a negative determination has been made on the issue described in article 17D(3) of this Act, if the sole application of other measures is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within an appropriate timeframe.</p> <p>Pillar II provisions have strengthened the MFSA’s remit in the area of capital adequacy.</p> <p>Subsequent to the 2003 FSAP, the on-site examination report formats were amended to incorporate the FSAP recommendations, and further, if there are material differences between the ratings assigned by the bank and those assigned by MFSA, the impact of changes to provisions and the capital adequacy ratios are discussed and disclosed in the reports. This procedure is included as part of the General Instructions for On-Site Examinations.</p> <p>The MFSA also now has legal authority in BR/09 to require an institution to make the necessary adjustments to provisions and ultimately to earnings and capital.</p> <p>In respect of own funds, the term “sufficient” is interpreted to encompass all of an institution’s risks. Thus, if a bank’s own funds are not covering all risks embodied in Pillar I and Pillar II, then the level of own funds is not “sufficient.” The authorities indicated that consideration will be given to incorporating the sufficient threshold into a policy framework for corrective measures and enforcement actions.</p> <p><i>Additional criteria:</i> None</p>
<b>Principle 7.</b> [new CP added in 2006 revision of Core Principles]	<p><b>Risk management process</b>  <b>2002/3 FSAP – (not applicable); 2010 Independent Assessment – Compliant</b></p>
	Articles 17B, C and D of the BA, added in 2007; address Internal Governance, Internal

Capital Adequacy Assessment Process (ICAAP), and Supervisory Review and Evaluation Process (SREP), respectively. In addition, BR/12-Supervisory Review Process of Credit Institutions (authorized under the Banking Act 1994) was introduced in 2009; it is modelled on the European Union Directive 2006/48/EC and relevant CEBS Guidelines. The following Appendices and Annexes are included to ensure that credit institutions have sufficient capital to support all material risks inherent in their business activities.

Appendix 1 – Internal Governance

Appendix 2 – ICAAP

Annex 2A: ICAAP Report – Recommended Structure

Annex 2B: Technical Criteria on Organization and Treatment of Risks

Annex 2C: List of Definitions

Annex 2D: Principles on Stress Testing

Annex 2E: Principles for Remuneration Policies

Annex 2F: Principles for the Management of IRRBB

Annex 2G: Principles for the Management of Concentration Risk

Annex 2H: Principles on Risk Management

Appendix 3 – SREP

Annex 3A: SREP-ICAAP Interaction Process

Annex 3B: Technical Criteria on SREP

Annex 3C: Prudential Measures.

(1) The MFSA introduced BR/12, Supervisory Review Process of Credit Institutions, whereby all banks are required to develop an ICAAP. The ICAAP requires banks to have a comprehensive process to identify, evaluate, monitor and mitigate all risks. Banks are then required to develop methods to calculate the amount of capital necessary for each risk and any buffer over and above the regulatory minimum requirement. Each bank must submit its ICAAP to the MFSA annually while ensuring that the process is on-going.

After receipt of an ICAAP, the MFSA conducts a SREP to validate the contents of the ICAAP. To date, on-site visits have been conducted for those banks deemed systemically important; desk-based exercises have been conducted for all other banks. The results of SREPs have been communicated to the banks with indications of actions required to ensure adequate capital for the size and complexity of the institution.

(2) BR/12 includes an extensive appendix which specifies internal governance principles that banks must implement and adhere to. MFSA monitors and ensures implementation of the requirements of the rule.

(3) The MFSA is able, on the basis of the SREPs, to ensure that appropriate risk management policies, procedures and limits are documented, implemented and regularly reviewed, and that exceptions are promptly corrected.

(4) Performance of an ICAAP is the responsibility of a bank's board of directors. During an SREP, the MFSA reviews minutes of the board and its committees to ensure that relevant risks are properly identified, measured, and mitigated. Evaluations are also made to ensure that board policies are adequate in scope and fully implemented.

(5) Local retail banks do not yet employ models for their capital adequacy requirements but a provision in BR/12 covers such and there are references in the ICAAP Framework (Annex 2A) for such. A number of local banks do use models to measure

	<p>risk but such models are largely used to provide additional information for decision making by management. The use of these models for capital adequacy purposes must be approved by MFSA.</p> <p>(6) The MFSA ensures that specific banking risks are thoroughly addressed pursuant to the following individual BRs:</p> <ul style="list-style-type: none"> <li>BR/04: Credit risk</li> <li>BR/08: Market risks</li> <li>BR/05: Liquidity risk</li> <li>BR/12: Interest rate risk in banking book (Annex 2F)</li> <li>BR/04: Operational risk.</li> </ul>
<p><b>Principle 9.</b> [formerly CP 8]</p>	<p><b>Problem assets, provisions and reserves</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b></p>
	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> MFSA has considered the issue of collateral valuation guidelines in reply to previous internal audit exercises. Although the MFSA may lack the expertise and technical knowledge necessary to develop class-specific collateral guidelines, the role of the regulator is not to set rules for valuing collateral but rather to determine whether a bank has adequate procedures for evaluating the quality of collateral and the assumptions supporting values, and further whether a bank periodically re-assesses collateral to ensure adequate security coverage.</p> <p>The classification criteria in BR/09 provided for the earlier identification of problems and more pro-active provisioning for potential loss. Some changes may be necessary to reconcile with EU standards and IAS/IFRS; however, the existing methodology appears adequate for the local context.</p> <p>The MFSA recognizes that there is heavy reliance on property as collateral within Malta; however, adoption of a national real estate price index requires technical input from the Central Bank, the NSO, the local Chamber of Architects, and other entities. While not explicitly addressed in the on-site examination manual, the MFSA reviews collateral valuations prepared by independent, bank-appointed architects to evaluate the reasonableness of assumptions and conclusions.</p> <p>The MFSA also notes that the provisioning requirements contained in BR/09 are more stringent than EU requirements. On average, banks discount the market values of pledged properties by approximately 30% thereby creating a level of comfort that loan portfolios are not inflated by fluctuations in market valuations of properties. In January 2008, the MFSA formalized the discounting process in BR/04 and the Capital Requirement Directive (CRD) by requiring a 30% discount on residential properties and a 50% discount for commercial properties.</p> <p>Revisions are pending to IAS 39, which once finalized, will be adopted in BR/09 so as to reconcile to the extent possible this Rule with IFRS. The MFSA established an internal working group (together with representatives from the CBM) in July 2010 to review BR/09 and make recommendations for changes where necessary. The review will also include the requirements for upgrading classified assets, returning NPL's to accrual status and re-booking loans that previously were written-off. The goal of these efforts is to ensure that banks accurately and timely grade assets, that exposures are well supported by realistic collateral values, and provisions are fully adequate to reflect loss potential.</p>

	Regarding credit analysis, on-site examiners continue to include individual loan write-ups in examination reports, and all credit risk reports include a re-calculation of the capital ratio when down-grading of credit facilities results in higher levels of loan loss provisions, and the final conclusions of the inspection indicate these results.
<b>Principle 11.</b> [formerly CP 10]	<b>Exposures to related parties</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Largely Compliant</b>
	<p><b>Essential Criteria:</b> Following the recommendation of the 2002/3 FSAP Banking Rule BR/11 extension of the applicability of the arm’s length principle by credit institutions authorized under the Banking Act 1994 was issued pursuant to the proviso to article 15(1) (a) (b) of the Act - Prohibited Transactions. This rule extends the applicability of the “arm’s length” principle both in relation to the granting of credit facilities and to the extension of other banking services by credit institutions. Thus, in granting credit facilities and in extending banking services, credit institutions shall have procedures to ensure that the connected persons are not granted nor have outstanding credit facilities or other banking services under terms more favourable than those applied to other persons.</p> <p>BN/03-Internal Control Systems and BN/01-Credit Risk Management – both issued by the MFSA as best practice guidelines - require prudent segregation of duties and prudent underwriting standards, respectively.</p> <p>Reports submitted by banks to the MFSA provide information on aggregate lending to connected and related parties and include indebtedness of executive management, significant shareholders (and their related interests), or bank auditors.</p> <p>The definition of connected parties has been amended to conform to EU Directives and thus addresses recommendations [i], [ii], and [iv] above. The latest amendments relate to 2006/48/EC and further changes will be required in respect of Directive 2009/111/EC (CRDII). Although specific limits exist in respect of unsecured exposures to connected parties, there are no limits on the aggregate exposures to all connected persons.</p> <p>In respect of recommendations [iii] and [v] above, the Banking Act and Rules do not set specific thresholds for abstaining from voting nor is there a requirement to deduct connected party exposures from capital; however, the authorities indicated they will give further consideration to these matters and to establishing aggregate limits for exposures to all connected persons.</p>
<b>Principle 13.</b> [formerly CP 12]	<b>Market risks</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b>
	<p><b>Essential Criteria:</b> Market risk is integrated into the ICAAP document for internal capital requirement purposes and to the ICAAP-SREP interaction process. Specific limits for foreign exchange risk were removed with adoption of the Euro in 2008, although retaining limits for net open positions in terms of the relevant provisions found in BR/08 in non-Euro currencies may be justified.</p> <p>The MFSA has, thus far, conducted regular off-site analyses for all banks and on-site inspections at the major banks in order to evaluate market risk. Following introduction of BR/12, the MFSA is also conducting a review of all material risks in banks including</p>

	<p>market risk.</p> <p>During on-site inspections, examiners determine whether limits, systems and controls exist and confirm compliance. Thus far, there have been no occasions for the MFSA to impose limits on locally-licensed banks.</p> <p>The MFSA maintains close communication and continuous exchange of information with the CBM regarding market risks and stability of the financial system, both formally and informally. Under auspices of the Domestic Stand Group, the MFSA and the CBM have in the past three years conducted crisis management simulation exercises as well as a systemic impact assessment during 2009.</p>
<b>Principle 14.</b> [formerly CP 13]	<b>Liquidity risk</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b>
	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> The MFSA intends to amend BR/05 to incorporate the relevant provisions from CEBS and BIS Guidelines on Liquidity Buffers and Liquidity Risk Management. Moreover, the MFSA requires institutions to actively monitor and mitigate their Liquidity Risk on a day-to-day basis and to provide details of Liquidity Funding Contingency Plans in ICAAP assessments.</p>
<b>Principle 15.</b> [formerly CP 13]	<b>Operational risk</b> <b>2002/3 FSAP – (not applicable); 2010 Independent Assessment – Compliant</b>
	<p>BR/04 Appendix 4 requires credit institutions to hold own funds against operational risk in accordance with the methodologies set out in three approaches: Basic Indicator Approach; Standardised Approach; and Advanced Measurement Approach. CEBS also provides guidelines on Operational Risk Mitigation Techniques.</p> <p>BR/12, Annex 2H requires banks to implement general risk management principles as adopted from the equivalent CEBS guidelines. Such guidelines encompass control and mitigation of operational risk.</p> <p>Following issue of Basel II/EU Directive 2006/48/EC, banks now are required to allocate capital for operational risk through BR/04 and for Pillar II risks through BR/12.</p> <p>The MFSA indicated that specific CEBS guidelines contained in the “Compendium of Supplementary Guidelines on Implementation Issues of Operational Risk” will be reviewed with a view to incorporating them into BR/12 or BR/04.</p>
<b>Principle 16.</b> [formerly CP 13]	<b>Interest rate risk</b> <b>2002/3 FSAP – (not applicable); 2010 Independent Assessment – Compliant</b>
	<p>BR/12, Principles for Management of Interest Rate Risk in the Banking Book (IRRBB), outlines principles for institutions and provides guidance for supervisors.</p> <p>Banks are required by BR/12, Annex 2F (adopted from CEBS Guidelines) to implement specific principles for managing IRRBB, and the MFSA emphasizes the principle of proportionality.</p>

	<p>The requirements of BR/12 are applied by the MFSA in a proportionate manner to reflect the nature, scale and complexity of the activities of an institution and are reflected accordingly in ICAAPs and SREPs. Although a formal definition of proportionality does not yet exist, the MFSA requires institutions to apply the concept in practical terms relative to the size and complexity of the institution. It is also noted that the majority of loans in banks' loan portfolios are on a variable rate basis and the bulk of deposits are non-interest-bearing demand deposits or short-term time deposits, thereby mitigating interest rate risk.</p>
<p><b>Principle 17.</b> [formerly CP 14]</p>	<p><b>Internal control and audit</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b></p>
<p>Description</p>	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> BR/01 refers to the need for a mix of executive and non-executive directors on boards of directors of banks and BN/03 (on Internal Control Systems) addresses the role of boards and management in the internal control process. Examiners test against this guidance in the examination process. The Maltese banks are encouraged to have an Audit Committee (requirement for listed institutions) that is composed entirely of non-executive Directors.</p> <p>When conducting SREPs, the MFSA evaluates corporate structure, internal governance, and the internal controls of an institution. Within this context, BA Art 17B was added to the Banking Act in 2007 to address internal governance and BR/12 incorporates CEBS requirements; relevant appendices of BR/12 provide explicit principles.</p>
<p><b>Principle 18.</b> [formerly CP 15]</p>	<p><b>Abuse of financial services</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b></p>
	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> The FIAU has the primary responsibility for assessing compliance with laws and regulations in this area. Considerable progress has been achieved by the FIAU since its establishment in October 2002. The relevant AML/CFT regulations have been reviewed in the context of the Third Money Laundering Directive and revisions made to conform. The MFSA cooperates with FIAU to achieve adherence to this criterion. Guidance Notes drafted by the FIAU have now been issued for consultation.</p> <p>Training for AML/CFT matters is now conducted by the FIAU, and several initiatives have been organized in this area over the years. A training seminar on ML/FT was held in 2009 for the MFSA staff, and inspectors from the Banking Supervision Unit continue to participate in international fora.</p> <p>During on-site inspections, banks' internal guidelines are reviewed to assess compliance to the new regulations and examiners collect information on behalf of the FIAU during on-site inspections. FIAU inspectors may participate in conjunction with the MFSA's on-site inspection or carry out their own assessment at licensed subject-persons.</p>

<b>Principle 19.</b> [formerly CP 17]	<b>Supervisory approach.</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Largely Compliant</b>
	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> Given the relatively low number of banks authorized locally, the MFSA has developed and maintained a thorough and forward-looking understanding of the operations and risk profiles of individual banks and the banking system; complex banking groups do not, at present, exist in Malta. Liaison and collaboration with the CBM on many issues not only on a formal basis through the auspices of the CBM/MFSA Standing Committee, but also in the stress testing of individual banks, has provided valuable knowledge on the system in aggregate.</p> <p>Officials in the Banking Supervision Unit acknowledge the value of conducting meetings with the boards of directors and had started doing so after the FSAP in 2003; however, it was necessary to suspend the meetings in 2007 when CRD priorities took precedence. Officials indicated that meetings with boards will be resumed before YE-2010 [refer also to CP-20 below].</p> <p>At a minimum, two types of meetings are recommended: (i) an annual tri-partite meeting involving the MFSA, the external auditor, and bank senior management (including the internal auditor), the purpose of such meeting being to review the results of the annual external audit; and (ii) a meeting with the board of directors of a bank following each full scope examination, the purpose being to review the findings and conclusions of the examination and to solicit feedback from non-executive directors and allow them to ask questions directly to the regulator.</p>
<b>Principle 20.</b> [formerly CP 16]	<b>Supervisory techniques.</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Largely Compliant</b>
Description	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional Criteria:</i> Reports of on-site examinations now address many aspects of bank conditions and performance including, inter alia, credit quality, risk management processes, bank management and board oversight. Moreover, reports have been tailored to incorporate recommendations offered by previous FSAP assessors.</p> <p>Acting on recommendations in the 2003 FSAP, the MFSA-BSU began holding meetings with boards of directors of several banks, and there are various other occasions where MFSA officials meet with executive managers and directors of institutions. Due to priorities of CRD transposition and the implementation of ICAAPs and SREPs, regular meetings were suspended but will be resumed later in 2010 [refer also to CP-19 above].</p> <p>A priority is the need for additional experienced personnel in order that the Banking Supervision Unit can fulfil its increasing responsibilities for on-site inspections, ICAAPs, SREPs, enhance compliance with all CRD’s requirements, and the full array of risk assessments.</p>
<b>Principle 21.</b> [formerly CP 18]	<b>Supervisory reporting</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b>

and 19 ]	
	<p><i>Essential Criteria:</i> None.</p> <p><i>Additional criteria:</i> The Banking Supervision Unit has a formal inspection manual that is comprehensive and includes detailed guidance for conducting inspections, part of which includes verifying the accuracy and reliability of data submitted to the MFSA in off-site returns.</p> <p>The Banking Supervision Unit is meanwhile in the process of updating the inspection manual and re-starting regular meetings with banks' boards of directors.</p>
<p><b>Principle 23.</b> [formerly CP 22]</p>	<p><b>Corrective and remedial powers of supervisors</b> <b>2002/3 FSAP - Materially Non-compliant; 2010 Independent Assessment – Largely Compliant</b></p>
	<p><i>Essential Criteria:</i> The practice of moral suasion had been demonstrated to work reasonably well in the Maltese context; especially given the risk of reputational damage to an institution should a sanction imposed by the MFSA be publicly disclosed. However, officials agreed that a formal policy for initiating corrective measures and regulatory enforcement actions would be beneficial going forward. For optimal benefit, the policy should link the form and content of a regulatory response to objective, measurable criteria regarding the nature and severity of condition and operations, e.g. capital adequacy, violations of laws or rules, unsafe or unsound banking practices, mismanagement. The policy also should provide for progressively more restrictive requirements as risk increases. Notwithstanding the value of prescriptive "if-then" guidelines, the policy should be sufficiently flexible to allow for judgment and discretion so that responses can be tailored to unique circumstances.</p> <p><i>Additional Criteria:</i> Regarding recommendations made in 2003 (see above), officials noted the following changes:</p> <p>[1] bank boards of directors now receive formal reports of inspection and are required to sign an acknowledgement form indicating that they have received and read the reports;</p> <p>[2] reports of inspection now incorporate quantitative data showing the impact of asset classifications and provisions on earnings and capital; also, management's responses to examination findings are considered and factored into subsequent supervisory strategies;</p> <p>[3] material differences between banker classifications and MFSA classifications are incorporated into assessments of provisions, earnings and capital and, where appropriate, are indicated as breaches of regulations; BR/09 regarding asset classifications and provisioning has significantly reduced differences;</p> <p>[4] MFSA-BSU officials agreed that a policy for applying graduated corrective measures and enforcement actions would be beneficial and efforts will be taken to formalize existing practices, which are largely in line with standard prompt corrective action methodologies;</p> <p>[5] penalties for breaches of laws are fixed in law and while they appear nominal, public disclosure of a penalty or sanction is more a deterrent than the quantum of a penalty.</p>
<p><b>Principle 25.</b> [formerly CP 24 and 25]</p>	<p><b>Home-host relationships</b> <b>2002/3 FSAP – Largely Compliant; 2010 Independent Assessment – Compliant</b></p>

	<p><b>Essential Criteria:</b> It is being proposed also that BA Art. 11 will be amended in Sept-2010 to explicitly prohibit a credit institution licensed in Malta from opening a branch, subsidiary or representative office in a third country (a non-EU country) where the secrecy laws or other regulations of that country prohibit the information flows deemed necessary for adequate consolidated supervision.</p> <p><b>Additional Criteria:</b> Actions taken by the MFSA since 2003, particularly as regards information-sharing and regulatory cooperation agreements, have addressed concerns raised previously.</p>
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In response to the Assessors comments, the Banking Supervision Unit has drawn up explanations/lines of action in relation to those Core Principles where the Assessors did not deem that sufficient progress has been made so as to merit a **Compliant** grade. Such comments are specified hereunder.

**TABLE 2.2 MFSA RESPONSE (BANKING SUPERVISION UNIT) TO THE 2010 INDEPENDENT ASSESSMENT**

Core Principle	Comments
1.2	The question of recruitment as well as the retention of well-qualified and experienced personnel is one faced by all supervisory units within the MFSA. Accordingly, given the ever more comprehensive evolution of regulatory requirements within the EU, the MFSA will continue to dedicate appropriate resources for training and develop appropriate career structures for staff to undertake the increasingly complex role of banking regulation and supervision.
11.	<p>As part of the oversight of banks, the BSU continuously monitors the situation in respect of all connected lending by means of data received at the Off-Site Section through the statutory information submitted by banks as required by Banking Rule BR/06. Schedule AD which forms part of the package of statutory returns in BR/06 requires banks to report on a quarterly basis loans on the following categories of connected persons:</p> <ul style="list-style-type: none"> <li>- Directors and connected /related parties;</li> <li>- Staff members and connected /related parties;</li> <li>- Significant and qualifying shareholders and connected/related parties;</li> <li>- (External) Auditors and connected/related parties.</li> </ul> <p>Moreover, on-site inspections may also be undertaken specifically in order to gauge that the level of connected lending disclosed in the prudential returns reflects the reality of any lending. As to whether CRD requirements actually stipulate that the total of connected party exposures should be deducted from capital adequacy, it should be noted that loans to staff are not considered as connected person in terms of the CRD. However, even though this area has so far not given cause of concern, the BSU will continue to monitor its development and if necessary, the powers provided to the MFSA under the Pillar II process will be utilized to tackle any concerns generated by a particular bank in this area.</p>
19-20	The BSU acknowledges the value of conducting meetings with the boards of directors and had started doing so after the IMF/WB FSAP in 2003. However, it was necessary to suspend the meetings in 2007 when priorities relating to CRD

	<p>implementation took precedence. It should be noted that meetings with boards of banks have now been resumed. On September 16, 2010, a meeting was held with the board of directors of one of the Austrian subsidiaries.</p> <p>It should also be pointed out that the BSU already holds tripartite (MFSA/bank/auditors) or bipartite (MFSA/auditors) meetings (depending on circumstances) when auditors' findings indicate the need to do so, or when a specific request is made by the auditing firm. The BSU believes that meeting the Board at the conclusion of each full-scope on-site inspection concluded by its inspectors will add value to the overall assessment of the bank's internal governance framework. The BSU will, in future strive to hold meetings with banks' Boards of Directors as frequently as possible, always keeping in mind the risk-based approach to supervision adopted by the BSU and resources available. However, it should be emphasized that holding such meetings with a full board may sometimes be difficult to arrange as various banks having board members who reside overseas.</p>
23.	<p>The BSU is of the opinion that legislation as currently drafted is adequate for applying corrective measures. However, in order to strengthen even further this area, the BSU will, in the near future, be formalizing and improving on the existing informal framework currently applied when taking corrective measures and enforcement actions so that the application of these measures would be officially formalized and implemented.</p>

The independent assessors also commented on updates relating to positive measures which have been taken by the MFSA – BSU since the 2002/03 IMF Mission's assessment, in relation to aspects of those Core Principles which had already been rated as Compliant by the same IMF Mission.

### 3. Implementation of the IOSCO Objectives and Principles of Securities Regulation

#### Introduction

An independent assessment to update the 2002/3 FSAP assessment was conducted during July 27-31 and September 6-7, 2010 by Piero Ugolini - former Assistant Director /IMF and mission chief of the IMF/WB team that conducted the 2002/3 FSAP exercise.

#### 3.1 Main Regulatory Developments since 2002/3

Since Malta's accession to the EU in 2004, the Maltese financial market has been fully adjusted to comply with EU law in the field of the regulation of financial services, including the regulation of securities business. The following major developments have taken place:

- adoption of the Prevention of Financial Markets Abuse Act by virtue of which Malta transposed and implemented the EU Market Abuse Directive.
- the Investment Services Act, 1994 ("ISA"), the Financial Markets Act, 1990 ("FMA") and the regulations and rules issued thereunder were subject to significant amendments for the purpose of transposing the EU Markets in Financial Instruments Directive. The FMA was also amended to provide for the regulation of Central Securities Depositories ("CSDs"). Legislative changes were made to the FMA to remove reference to the Stock Exchange from the Act and as from 1<sup>st</sup> November, 2007, the Malta Stock Exchange plc (a company established in Malta) took over the personality of the Malta Stock Exchange. On the same date, MFSA issued a licence to this company to operate a regulated market and a central securities depository. The Malta Stock Exchange plc is currently a company fully owned by the Government of Malta.
- The MFSA has been appointed as Listing Authority and is now responsible for all matters relating to the admissibility to listing of a security on a regulated market. The Listing Authority has issued its Listing Rules which apply to companies seeking to obtain admissibility to listing and also serve to transpose the requirements of the EU Transparency Directive besides the Prospectus Directive.

#### 3.2 Principle-by-Principle Assessment

A Principle is considered **implemented** whenever all assessment criteria are generally met without any material deficiencies. The Principles acknowledge that there are often several ways for countries to implement the Principles. A Principle is considered to be **broadly implemented** whenever only minor shortcomings are found, which do not raise major concerns and when corrective actions to achieve full implementation with the Principle are scheduled and realistically achievable within a short period of time. A Principle is considered **partly implemented** whenever significant shortcomings are found, and the authorities have

not implemented one or more assessment criteria. The difference between implemented and partially implemented may in part depend upon the improvements needed and on doubts as to the authorities' ability to implement within a reasonable time-frame. A Principle is considered **non-implemented** whenever major and material shortcomings are found in adhering with the assessment criteria. A Principle is considered **not applicable** whenever it does not apply given the structural and institutional conditions.

As a result of the progress made since 2003 this independent assessment has concluded that the MFSA has "Implemented" twenty-four Principles (versus twenty-two in 2003) and has "Broadly Implemented" four Principles (versus six "Partially Implemented" in 2003). Two Principles remain "Not Applicable" (Table 3.1).

**Table 3.1. Summary Observance of the IOSCO Objectives and Principles of Securities Regulation**

2002/3 FSAP Assessment	Principles Grouped by Assessment Grade	
	Grade	Count
Implemented	22	1; 2; 4; 5; 8; 9; 10; 11; 12; 13; 15; 16; 17; 18; 19; 20; 21; 25; 26; 27; 28; 29;
Broadly Implemented	0	
Partially Implemented	6	3; 14; 22; 23; 24; 30
Non-Implemented	0	--
Not applicable	2	6, 7

<u>2010 Update</u>	Principles Grouped by Assessment Grade	
	Grade	Count
Implemented	24	1; 2; 4; 5; 6;7;8; 9; 10; 11; 12; 13;14; 15; 16; 17; 18; 19; 20; 21; 25; 26; 27; 28; 29;30
Broadly Implemented	4	3; 22; 23; 24
Partially Implemented	0	
Non-Implemented	0	--
Not applicable	2	6, 7

In summary, out of the 30 principles, MFSA has fully implemented 24 including 2 which were up-graded from a partially implemented status in the 2002/3 assessment, 2 are not-applicable and 4 were upgraded from a partially implemented status given in the 2002/3 assessment to a broadly implemented status. There are no instances where any of the principles have not been implemented. This compares favourably with the 2002/3 assessment, in terms of which MFSA was indicated as having implemented 22 principles and partially implemented 6 principles (2 principles were not applicable).

### **3.3 Comments on the Principles whose Status has been Upgraded in the 2010 Assessment.**

The following table includes a summary of the salient points made by the Assessor regarding improvements registered with respect to those principles whose status has been updated in the 2010 assessment.

**Table 3.2 Comments Regarding Principles Whose Status has been Updated in 2010**

<b>IOSCO Principle</b>		<b>2002/3 FSAP</b>	<b>2010 Assessment</b>	<b>Comments</b>
3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers	PI	BI	The MFSA has addressed one of the main shortcomings noted in the original assessment. As of January 1, 2010, the Securities and Markets Unit of the MFSA is responsible for all the securities regulation in Malta. The MOU between MFSA and CBM in May 2003 clarifies the role of the two institutions. In 2007 the FMA was amended to include inter alia a specific section for the regulation of the CSD and addresses the previous lack of a clear legal basis for the regulation and supervision of the CSD which was a principal weakness which had been identified in the 2002/3 assessment. The MFSA has undertaken a correct policy of recruiting and training staff to meet new challenges in the supervision of the financial sector- However, the on-going growth of the financial sector has put some strain on the MFSA staff resources and it will be important to continue and intensify such a policy to

				meet present and future challenges. Additional staff is being recruited in the Securities and Markets Supervision Unit. However, the 2005 OPM Circular has delayed considerably the time needed for recruiting staff in the MFSA. As a result of the cumbersome process and administrative layers under which the MFSA has to operate the recruitment process could take several months and impact on the workload of the MFSA staff.
14.	There should be full, accurate and timely internal disclosure of financial results and other information that is material to investors' decisions	PI	I	All issues raised in the 2003 assessment in relation to this Principle have been satisfactorily addressed through the issue of MFSA's Listing Rules.
22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake	PI	BI	The MFSA has transposed the requirements to implement Pillar 1, 2, and 3 of the EU Capital Requirements Directive. These actions fully address the concerns and comments of the 2003 evaluation. However, in view of the tight capacity of human resources, the time for the review of the capital levels of market intermediaries is, at times, longer than normal. The authorities are addressing this shortcoming by recruiting additional staff
23.	Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.	PI	BI	MFSA's Investment Services Rules require market intermediaries to identify the risks relating to their activities, processes and systems and to manage these risks effectively. These have been supplemented by Guidance Notes on Risk Management and Internal Capital Adequacy. As in the case of Principle 22, the limited human resources, at times, cause some delays in the schedule of periodic evaluation of internal controls and of risk management processes implemented by the market intermediaries.
24.	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss	PI	BI	The MFSA has drawn up an internal procedure which provides guidance on how the Authority should deal with a possible failure of a market intermediary. Moreover, guidelines on

	to investors and contain systemic risk			business continuity were issued to market intermediaries and the Investor Compensation Scheme Regulations have in the meantime been enforced. The supervisory authorities have addressed the two actions highlighted in the 2002/3 assessment and an upgrading of the assessment was granted. However, the authorities should accelerate the completion of the revision of their internal early warning system to better evaluate a potential default by market intermediaries, address the problem, and take timely corrective actions.
30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designated to ensure that they are fair, effective and efficient and that they reduce systemic risk.	PI	I	The amendments to the FMA, primarily the introduction of the new Part IV titled “Central Securities Depository”, have addressed the weaknesses identified in the 2002/3 assessment by clearly setting out the legislative foundation for the regulation of CSD services and for the dematerialization of securities so as to provide legal certainty as to the ownership of dematerialized securities the register of which is maintained by a CSD.

### 3.4 Recommendations

The following was recommended to improve observance by the MFSA of the IOSCO Objectives and Principles of Securities Regulation:

**Table 3.3 Recommended Plan of Actions to Improve Observance of the IOSCO Objectives and Principles of Securities Regulation**

Reference Principle	Recommended Action
Principles Relating to the Regulator (CP 1–5)	<p>Clarification would be in order as regards the regulation and supervision of the CSD and CSS functions and the related institutional arrangements.</p> <p>The MFSA’s and the MSE’s responsibilities, applied procedures and required lines of reporting should be explicitly established to optimize use of scarce resources and ascertain coverage with no supervisory, surveillance or enforcement gaps.</p> <p><b>2010 Update:</b> Appropriate action has been taken to address the above through legislative changes and enhancements to the local regulatory framework as further detailed in the</p>

Reference Principle	Recommended Action
	<p><b>Principle by Principle 2010 Update.</b></p> <p><b>The MFSA has to continue pursuing the policy of remaining updated new products offered in the financial sector. In view of the growing financial sector and new challenges, the MFSA has to continue its policy of recruiting and retaining qualified staff. Appropriate and continuous training for the MFSA staff and outside assistance from experienced officials in the financial sector area should continue.</b> The recruitment process must be streamlined and shortened.</p>
Principles of Self-Regulation (CP 6–7)	No action required.
Principles for the Enforcement of Securities Regulation (CP 8–10)	
Principles for Cooperation in Regulation (CP11–13)	No action required.
Principles for Issuers (CP 14–16)	<p>Reconsider the exceptions to the half-yearly disclosure requirement.</p> <p>Reconsider the 6 month lag allowed for issuance of audited annual accounts as it is long by international standards.</p> <p><b><u>2010 Update:</u> The MFSA Listing Rules have addressed the above and are in line with relevant EU Directives in this area</b></p>
Principles for Collective Investment Schemes (CP 17–20)	No action required.
Principles for Market Intermediaries (CP 21–24)	<p>The planned implementation of the EU Capital Adequacy Directive requirements should be considered.</p> <p>The overall solvency arrangements of the entire market structure, including the MSE and in particular, its CSD and CSS functions, should be reviewed and reconsidered. It is recommended that these exercises be conducted in coordination to ascertain that the solvency requirements of the individual market participants and market in general are not compromised, while taking into account the market’s capacity to bear the cost.</p> <p>The MFSA issue guidelines to the RIEs on risk management, particularly as regards the CSD and CSS functions.</p> <p>The MFSA should establish more detailed principles and procedures for dealing with failures of market intermediaries.</p>

Reference Principle	Recommended Action
	<p><b><u>2010 Update:</u> The EU Capital Requirements Directive (which replaced the CAD) has been transposed into the local regulatory framework and besides being applicable to investment firms, has also been used as a basis for the introduction of risk-based financial resources requirements for the Regulated Market and CSD.</b></p> <p><b>Risk Management guidance has also been issued and an internal procedure for dealing with the failure of an investment firm has been drawn up.</b></p> <p><b>Appropriate staff should be dedicated to review capital adequacy on a continuous basis and the early warning system should be formalized.</b></p>
Principles for the Secondary Market (CP 25–30)	<p>The Government should consider specific legislation both for the dematerialization of securities and the institutional infrastructure for CSD and CSS functions.</p> <p><b><u>2010 Update:</u> The above has been addressed through amendments to the Financial Markets Act and the issue of Regulations</b></p>

### **3.5 MFSA Response (Securities and Markets Supervisory Unit) to the 2010 Independent Assessment:**

***Principles Relating to the Regulator (CP 1-5):*** The MFSA recognises the importance of ensuring that its regulatory staff keep abreast with financial services industry developments. The Authority also recognises the need for recruiting and retaining appropriately qualified staff to enable it to carry out its supervisory duties effectively in the light of the growth in the number of licensed entities falling under its regulatory remit as well as in the light of the increasingly demanding regulatory standards (both European and international) which are expected of regulatory authorities. In this regard, a recruitment programme is currently underway to gradually augment the Securities & Markets Supervision Unit staff by recruiting graduates having some relevant industry experience and who can contribute to achieving the Unit’s objectives. Moreover, since the 2002/3 FSAP assessment, besides continuous investment in training for regulatory staff, arrangements have been made for the secondment of Unit staff both with other more experienced regulatory authorities, as well as with the industry. The MFSA is committed to continue exposing its staff in such manner.

***Principles for Market Intermediaries (CP 21-24):*** As indicated above, the staff resources available to the Securities & Markets Supervision Unit are being supplemented to enable it to better cope with its supervisory duties. These include the prudential regulation of investment services licence holders with a view to ensuring that they comply with the on-going requirements of the EU Capital Requirements Directive. In line with the recommendation made, the MFSA plans to enhance its internal procedure for dealing with the failure of a

market intermediary which it has drawn up since the 2003/3 FSAP assessment, to include a formalised internal warning system to better evaluate a potential default by a market intermediary, address the problem, and take timely corrective action. In this context, the SMSU is monitoring discussions at the EU level on the proposed crisis management directive.

## **4. OBSERVANCE OF INSURANCE CORE PRINCIPLES FOR INSURANCE AND PENSIONS SUPERVISION**

### **4.1 Introduction**

An independent assessment to review the effectiveness of Malta insurance legislation in the context of current insurance supervisory best practices (the ICPs) was carried out by Michael Kehr (BaFin, Germany) in July 2010.

### **4.2 Information and Methodology**

The independent assessment updates the 2002/2003 assessment carried out in the context of an IMF/World Bank Financial Sector Assessment Program (FSAP). The assessment reviews the effectiveness of Malta insurance legislation in the context of current insurance supervisory best practices (the Insurance Core Principles (CPs)). It also examines the effectiveness of the supervisory body, which is the Malta Financial Services Authority (MFSA).

The methodology employed in the 2010 independent assessment is based on the CPs of the International Association of Insurance Supervisors (IAIS) approved in October 2003 together with an IMF Template based on this methodology. In the light of the developed nature of the Maltese insurance market, the 2010 independent assessment comments on both the essential and advanced criteria underpinning each core principle. However, in accordance with Annex 2 of the Insurance Core Principles and Methodology, only essential criteria have been taken into account in assessing the overall level of observance of a core principle.

At the time of the 2002/2003 FSAP, the IAIS Insurance Core Principles consisted of 17 Core Principles based on standards adopted in 2000. In view of the all-embracing changes not only of the market environment and supervisory framework, but also of the Insurance Core Principles themselves (the standards adopted in October 2003 increased the number of principles from 17 to 28)), an update of the 2002/2003 FSAP through a principle by principle review was not carried out.

The 2010 independent assessment was based on the following information:

- A self-assessment prepared by the MFSA,
- EU-Directives, national laws, rules and regulations,
- Procedures, checklists, files, off- and onsite reports and correspondence,
- Interviews with MFSA staff, insurance undertakings under supervision and other stakeholders.

The 2010 independent assessment was greatly facilitated by the detailed Self-Assessment and other information supplied by the MFSA as well as other participants from the public and private sector.

### 4.3 Assessment

**Table 4.1: Summary Observance of IAIS Insurance Core Principles [2010 Independent Assessment]**

Assessment Grade	Count	Principles Grouped by Assessment Grade
Observed	22	1,2,4,5,6,7,8,11,12,14,15,16,17,19,20,22,23,24,25,26,27,28
Largely observed	4	3, 9,18,21
Partly observed	2	10,13
Non-observed	0	0
Not applicable	0	0

The overall 2010 independent assessment is that the MFSA observes most of the 28 CPs and following key recommendations were made:

- a) The MFSA's supervisory framework for internal audit functions needs to be tighter. Companies should be required to have internal audit functions. Supervision of internal audit functions should be strengthened.
- b) On-site inspections should be assigned the necessary staff and time resources. Work on enhanced planning procedures needs to be continued. Follow up actions should be stricter.
- c) As the number of ICPs has since the 2002/2003 FSAP increased from 17 to 28, (Table 4.1) it is very difficult to carry out a principle by principle review. However, the observance resulting from the 2002/2003 FSAP is reproduced in Table 4.2 for comparative purposes.

**Table 4.2. Summary Observance of IAIS Insurance Core Principles [2002/2003 FSAP]**

Assessment Grade	Principles Grouped by Assessment Grade	
	Count	List
Observed	12	1, 2, 3, 4, 7, 10, 11, 13, 14, 15, 16, 17
Broadly observed	3	8, 9, 12
Materially non-observed	2	5, 6
Non-observed		
Not applicable		

The recommendations and main observations resulting from the 2010 independent assessment are summarized as follows (the numbers follow the numbering of the CPs).

**Table 4.3: Recommended Actions to Improve Observance of IAIS Insurance Core Principles**

CP 2 – Supervisory objectives	Although this principle was assessed as "observed", the MFSA should consider expanding the scope of Art. 4 (2) of the Insurance Business Act (IBA) in a way that it is applicable also to ongoing supervision, thus arranging the objectives of insurance supervision to be more specific.
CP 3 – Supervisory authority	<p>Legislation should foresee that, in case of dismissal of a board member, the reasons shall be publicly disclosed.</p> <p>Cumbersome staff recruitment processes complicate MFSA's endeavours to hire qualified staff. Without enough well qualified staff, the MFSA would fall behind, could no longer discuss developments with the industry on eye-to-eye-level effectively, and could after all not cope with the challenges lying ahead in insurance supervision. These challenges are not to be underestimated as they mean, Europe-wide, a total paradigm shift in insurance supervision.</p>
CP 9 – Corporate governance	<p>Clarify that the setup of special committees means a material change to the layout of an insurance undertaking so that the MFSA needs to be notified. The Authority needs to be aware of the existence and setup of all relevant committees.</p> <p>Regarding remuneration policies, no principles have been established, e.g. in order to prompting companies to set incentives right, preferably in accordance with the G 20 resolutions and the subsequent FSB Principles for Sound Compensation Practices (and succeeding implementation standards) (April/Sept. 2009). The Corporate Governance Guidelines need to be amended specifically. The MFSA should ensure that these standards are actually being complied with.</p>
CP 10 – Internal control	<p>Recommendations and general guidance for the internal audit function have been established in 2009. The establishment of an internal audit function should be made mandatory.</p> <p>Supervision of internal audit functions should include planning and procedures of internal audit (time intervals, scope, units/functions that are subject to the audits). Attention should be paid to the separation of duties (internal audit units should not be charged with other tasks, i.a. to avoid from the outset a possible conflict of interest) and to the risk orientation of audit planning and conduct.</p>
CP 13 – On-site inspection	<p>The supervisory framework covers multiple aspects in a way of providing general guidance and principles.</p> <p>It is up to undertakings to fill this scope and find the appropriate procedures within this framework. It lies with the MFSA to check for the appropriateness and sufficiency of the procedures</p>

	<p>implemented by undertakings. While a part of this may be visible by means of off-site supervision, the largest part remains for investigation during on-site inspections:</p> <p>Sufficient resources, in terms of staff and time, should be dedicated to inspections.</p> <p>Inspections should focus and set clear priorities. The most relevant areas should be given necessary attention. When inspecting procedures established by undertakings, the Authority might want to see how procedures which insurers claim to have implemented actually work in practice, and trace the flow of information and reporting lines.</p> <p>Findings should be communicated consequently in all cases to undertakings with the proper emphasis and be followed up in the same way in the wake of inspections.</p>
<p>CP 15 – Enforcement or sanctions</p>	<p>Although this principle was assessed as "observed", the arrangements made for sanctions should be re-considered. As the scope of the general clause laid down in Art. 31A IBA well includes all kinds of situations, including those of more serious nature, a Level 1 administrative penalty seems not eligible as a deterrent.</p>
<p>CP 18 – Risk assessment and management</p>	<p>The MFSA and most market participants have started to move from a compliance oriented view and supervision to a more risk based approach. These efforts need to continue and systems shall be further developed.</p> <p>The MFSA should make sure that advanced tools of risk measurement and quantitative analysis are actually operative at company level. Such stress tests and scenario calculations should extend to both sides of the balance sheet.</p> <p>It seems recommendable to provide a framework and some guidance for market participants.</p> <p>Monitoring of the market should continue and take into account particularly that taking on a significant amount of more complex risks would imply sophisticated systems of risk management and probably – as a part of this – an asset liability management system including appropriate strategies for hedging.</p>
<p>CP 19 – Insurance activity</p>	<p>Notwithstanding the overall "observed" compliance rating for this principle, the MFSA should consider to remove legal uncertainties for undertakings in terms of what is considered to be a "material change" in terms of information duties in the wake of the authorisation process.</p>
<p>CP 21 – Investments</p>	<p>Sufficiently detailed requirements for the safekeeping of assets should be developed, also in order to establish more legal certainty for market participants.</p> <p>Such requirements might, for instance, stipulate that:</p> <p>Assets being held separately:</p> <ul style="list-style-type: none"> <li>• assets (other than cash) should be kept separate and distinct from the assets of the Custodian,</li> <li>• the Custodian's books of account must identify these assets</li> </ul>

	<p>clearly, Custodian's governance is flawless:</p> <ul style="list-style-type: none"> <li>• undertakings shall have a demonstrable process implemented to monitor and assess the performance of the Custodian on an ongoing basis,</li> <li>• undertakings shall regularly check and seek information from the Custodian as to its internal controls, organisation, staffing capabilities, administrative resources and arrangements for holding the assets.</li> </ul> <p>Financial position:</p> <ul style="list-style-type: none"> <li>• undertakings satisfy themselves that Custodians have financial strength to fully and in a timely manner meet their liabilities. In considering the Custodian's financial strength, undertakings should consider insurance or guarantee arrangements, and / or capital.</li> </ul>
CP 22 – Derivatives and similar commitments	Although this principle was assessed as "observed", the MFSA should review, from time to time, whether there is an increased use of derivatives and financial instruments in the market that calls for further development of rules and regulations for improved supervisory monitoring tools.
CP 24 – Intermediaries	Notwithstanding the overall "observed" rating for this principle, the MFSA should more use the full range of penalties available when imposing sanctions on supervised persons and entities, and see to it that they serve as a deterrent in the case considered.
CP 25 – Consumer protection	Although this principle was assessed as "observed", the MFSA might want to re-consider the arrangements made for the purpose of policyholder protection. With a particular view to long-term business, the low ceilings for compensation from the PCF almost render the purpose of the institution useless.

#### 4.4 MFSA Response (Insurance and Pensions Supervision Unit) to the 2010 Independent Assessment

Reference Principle	Authority's response
CP 2 – Supervisory objectives	The recommendation will be discussed with the Legal and International Affairs Unit.
CP 3 – Supervisory authority	The assessor's comments regarding the dismissal of a board member and the staff recruitment processes will be brought to the attention of the Board of Governors.
CP 9 – Corporate governance	<p><u>Special Committees</u></p> <p>Comments of are noted, however, it should be highlighted that Article 43(1) of the IBA imposes a requirement on a license holder to notify the Authority of any material changes in the documentation submitted at application stage and other documents submitted thereafter. It is to be noted that Insurance Rule 6 of 2007 requires the applicant to provide the MFSA, as part of the application information, with details of internal committees and</p>

	<p>their proposed terms of reference. Therefore, pursuant to article 43 of the Act any changes in these committees, as well as in their terms of reference, are to be notified to the MFSA.</p>
CP 10 – Internal control	<p>The comments and the recommendations have been noted. Indeed, the internal audit function is also mandatory under Solvency II.</p> <p>In this respect, the IPSU will certainly require the internal audit function to be made mandatory. However, it should be noted that out of the 45 authorised companies, 31 companies already have an internal audit function in place.</p> <p>It is being proposed that this requirement is brought in line with the requirements of ICP 10 with the transposition of the Solvency II Directive.</p> <p>Please refer to our comments for CP 13 with respect to the supervision of the internal audit function.</p>
CP 13 – On-site inspection	<p>The majority of license holders in the Maltese market are small undertakings with only two falling under the QIS 5 category of medium undertakings.</p> <p>Despite the limited resources available for on-site inspections the compliance visits, which are not targeted inspections, cover all the key areas of the operations of the entity being inspected. This also involves a careful review of the organizational structure, segregation of duties and reporting lines. In addition, officials perform a walkthrough of all systems relating to underwriting, claims handling, reinsurance and accounting with the relevant personnel. This includes a review of records, reports and software systems.</p> <p>With regard to the findings, the IPSU would like to point out that minor issues are not normally taken up with the entity in the circumstances when other more important issues have been identified during the same on-site visit. In these cases the Authority would not wish to detract attention from more important and substantive issues by raising issues which are considered to be of a non-substantive nature.</p> <p>Issues are always given due importance and followed up until a satisfactory resolution is achieved. The two on-site inspection reports reviewed by the independent assessor were followed up by correspondence with the respective entities and issues are constantly followed up. This correspondence is kept in separate files from the on-site report file and it may be the case that the relevant follow-up correspondence was not filed in the files that the reviewed by the independent assessor.</p>
CP 15 – Enforcement or sanctions	<p>Comments are noted. The IPSU will consider a revision in the level of penalties subject to the limits imposed by the IBA in Art. 67(6).</p>
CP 18 – Risk assessment and management	<p>Comments are noted. As rightly noted in the comments, the MFSA and most market participants have started to move from a</p>

	<p>compliance oriented view and supervision to a more risk based approach.</p> <p>There is always room for improvement and the IPSU will endeavor to provide a formal framework and guidance for market participants.</p>
CP 19 – Insurance activity	The recommendation will be discussed. It should be clarified that during the licensing process and on-site visits as well as during presentations made to Compliance Officers, the Authority explains that it expects any changes to the information submitted during or subsequent to the application stage to be notified so that the Authority is kept informed of changes on an ongoing basis.
CP 21 – Investments	The IPSU is currently studying the recommendation.
CP 22 – Derivatives and similar commitments	Comments have been noted. As explained during the independent assessment, all insurance companies are required to submit detailed management accounts including a detailed solvency computation, and a detailed schedule of assets, broken down by individual asset, indicating their balance sheet value and their value as computed in accordance with the requirements of the Insurance Business (Assets and Liabilities) Regulations, 2007.
CP 24 – Intermediaries	Comment has been noted.
CP 25 – Consumer protection	Comment has been noted.