MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular addressed to the investment services industry regarding the transposition of the Capital Requirements Directive ("CRD")

19th January, 2011

The CRD lays down the capital adequacy requirements applying to *inter alia* investment firms, the rules for their calculation and the rules for their prudential supervision, enabling competent authorities to evaluate the adequacy of such entities' own funds, having regard to the risks to which they are exposed. Its implementation has been mainly effected through a three phased approach: **[i]** firstly by transposing the Pillar 1 requirements in the Investment Services Rules for Investment Services Providers ("Rules") which relate to the calculation of the minimum capital requirement of investment firms depending on the type of investment service provided; **[ii]** secondly by implementing the Pillar 2 requirements which relate to the amount of internal capital that is considered adequate by investment firms in order to cover all the risks to which they are exposed; and **[iii]** thirdly by transposing the Pillar 3 requirements in the Rules which relate to the disclosure requirements of investment firms that allow market participants to assess the key information about the firm's underlying risks, models, controls and capital position.

The Second Capital Requirements Directive ("CRD II") and the Third Capital Requirements Directive ("CRD III")

As indicated in our circular dated 23rd February 2010, certain changes were effected to the CRD, which are being referred to as CRD II and CRD III. The purpose of this circular is to provide the investment services industry with: **[i]** a brief outline of CRD II and CRD III; and **[ii]** the manner in which the Authority has transposed these EU Directives in the local legislative framework.

N.B. Whilst all the necessary changes to transpose CRD II and part of CRD III in the MFSA's Rule book have been implemented, the MFSA's financial return has yet to be amended in order to incorporate the relevant updates, where this is required.

Part I - Outline of CRD II

During the year 2009 the European Commission, the European Parliament and the EU Council adopted CRD II, which is made up of three European Directives:

1. Commission Directive 2009/27/EC and Commission Directive 2009/83/EC amend certain Annexes to Directive 2006/49/EC of the European Parliament and of the Council as regards technical provisions concerning risk management. The purpose of this Directive is to amend certain technical provisions of Directive 2006/49/EC in order to ensure the convergent application of sound risk management practices applicable to credit institutions and investment firms.

2. Directive 2009/111/EC amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. The purpose of this Directive is to:
   - address shortcomings revealed by the financial crisis such as the failure to focus on the macro-systemic risks of failure of financial institutions;
   - establish the criteria for hybrid capital instruments which may form part of the eligible capital of investment firms. This serves the purpose of enhancing the quality of the capital that is held by investment firms;
   - establish colleges of supervisors in order to increase cooperation between the competent authorities and to enhance the supervision of cross-border groups, particularly in emergency situations;
   - introduce the notion of significant branches in order to reinforce the rights of host countries to information; and
   - improve the management of large exposures undertaken by investment firms.

Part II - The Third Capital Requirements Directive (CRD III)

On the 24th November 2010, the European Parliament and the EU Council adopted Directive 2010/76/EU amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies. The purpose of this Directive is to: **[i]** impose an obligation on investment firms to establish and implement remuneration policies that are consistent with effective risk management; **[ii]** strengthen the disclosure requirements of investment firms with respect to securitisation exposures; and **[iii]** require investment firms to hold higher capital requirements in relation to their trading book exposures and re-securitisation exposures.

Part III – The transposition of CRD II and III in the local legislative framework applicable to investment services licence holders

The transposition of the above-mentioned directives has been made by way of the adoption of the following:

Part B of the Investment Services Rules for Investment Services Providers

Amendment to SLC 1.23: This SLC has been amplified to include reference to the requirement for Investment Services Licence Holders to have a remuneration policy as required in terms of Directive 2010/76.

Amendments to SLC 7.45, SLC 7.48 and SLC 7.49:

SLCs 7.45 and 7.48 were mainly amended to refer to the inclusion of the Guidance Notes on Risk Management and Internal Capital Adequacy Assessment for Investment Services Licence Holders as Appendix 10 of the Investment Services Rules for Investment Services Providers, which now include guidance on the manner in which a licence holder should comply with the requirements on remuneration policies, liquidity risk and securitisation risk which are stipulated in Directive 2009/111 and Directive 2010/76. The Guidance Notes have been included in the rule book to provide for more legal certainty with regards to their applicability.

With regards to SLCs 7.45 and 7.49, amendments to the list of exempt licence holders were also effected with a view to require compliance only by licence holders falling under the scope of the CRD provisions. The disclosure requirements in terms of SLC 7.49 have also been increased to include the disclosures which licence holders are required to make with respect to remuneration policy and practices.

Additional amendments to enhance the Rules with respect to the financial reporting requirements of investment services licence holders:

Amendment to SLC 7.16: This SLC has been amended to refer to the required submission of the Annual Audited Financial Return within four months of the accounting reference date as is current practice.

Appendix 1 to Part B of the Investment Services Rules for Investment Services Providers

Section 1.2: Reference to the large exposures requirement as being applicable to category 1a; 1b; 2 and 4 investment services licence holders has been removed in compliance with the amendment to Directive 2006/49 introduced by Directive 2009/111.

Section 1.3.5: This section has been amended to clarify that the large exposures requirement only applies to category 3 investment services licence holders.

Section 2.3.4: An additional paragraph has been inserted in Section 2.3.4 of Appendix 1 to clarify the rule that credit derivatives which are recognised as a hedge of the non-trading book credit risk exposure must not be included in the trading book to calculate the capital requirement for the counterparty credit risk component. This is required in terms of Directive 2009/27/EC with regards to the amendment of Directive 2006/49/EC. The updated section 2.3.4 also refers to a new Annex 1A and Annex 1 B to Appendix 1 which deal with the credit risk mitigation techniques and the treatment of the counterparty credit risk component. Due to the introduction of these new Annexes, Annex 1 to Appendix 1, Specimen Subordinated Loan Agreement, has now been renumbered as Annex IV.

Section 4.1.1: This section which deals with Tier one capital with regards to the calculation of own funds, has primarily been amended to include: **[i]** the requirement that ordinary share capital is to fully absorb losses in going concern situations; and **[ii]** reference to other instruments eligible as tier one capital (hybrid capital). These requirements emanate from Directive 2009/111.

Section 4.1.2: This section stipulates the deductions from Tier two capital and has been amended to include a sub-section on *'Securitisation exposures not included in risk weighted assets'* as required in terms of Directive 2009/83. The updated section also refers to a new Annex V to Appendix 1 which deals with the calculation of the capital requirements for securitisation exposures. These requirements emanate from Directive 2006/48, which has been amended through Directive 2009/83 and Directive 2009/111. The Annex transposes the updated text.

Section 4.1.4: An amendment was made in order to set certain limits to the inclusion of hybrid capital instruments as required in terms of Directive 2009/111.

Section 4.2.1.1: This section which deals with the calculation of the credit/counterparty risk component has been amended to include reference to Annex VI to Appendix I which deals with the calculation of the advanced approaches to measure credit risk (Internal Ratings Based Approach). The requirements on the Internal Ratings Based models for calculating the credit risk set in Directive 2006/48 have been amended through Directive 2009/83, Directive 2009/111 and Directive 2010/76. The amendments also have the purpose of transposing the updated text of Directive 2006/48.

Section 4.2.1.1 has also been amended to update the exposure classes with regards to: **[i]** amounts receivable from EEA financial services licensed entities (exposure class 3); **[ii]** investments in collective investment schemes (exposure class 5); and **[iii]** other balance sheet items (exposure class 8), which were updated by Directive 2009/83 and Directive 2009/111. The former Directive also introduced a new class exposure with regards to EEA Financial Services Licensed entities and corporates for which a short term credit rating has been issued. This new exposure class has been included as exposure class 9 in section 4.2.1.1 of Appendix 1.

Section 4.2.2.1: This section which deals with the calculation of the position risk of all types of financial instruments with the exception of derivative financial instruments has been amended to include reference to Annex VII to Appendix I which deals with the calculation of the position risk component of credit derivatives. The requirements regarding the calculation of the position risk relating to credit derivatives are set in Directive 2006/49 and have been amended through Directive 2009/27. The amendments also have the purpose of transposing the updated text of Directive 2006/49.

This section has also been updated to include the amendments relating to the specific risk factor for the position risk component of traded debt instruments, which have been amended by way of Directive 2009/27.

Section 4.2.2.3: This section which deals with counterparty risk has been updated to include reference to Annex 1 B to Appendix 1 which deals with the treatment of the counterparty credit risk component of derivative instruments. The Annex transposes part of Directive 2009/27.

Section 4.2.4: The large exposures risk component, the calculation of which is explained in this section, has been amended to: **[i]** exclude certain claims from the calculation of the large exposures requirement; **[ii]** update the limits relating to this risk component and the exempt exposures; and **[iii]** provide an investment services licence holder with the option to treat a claim as having been incurred by a third party where the exposure to the client is guaranteed by the third party or secured by collateral issued by a third party. Moreover, the updated section on the large exposures risk component also amends the definition of connected clients and updates the methodology for the calculation of this risk component. The new requirements transpose part of Directive 2009/111.

Section 4.2.6: This section has been amended to include reference to the advanced measurement approaches to operational risk which are explained in Annex VIII. This Annex *inter alia* transposes part of Directive 2009/83.

Appendix 4 to Part B of the Investment Services Rules for Investment Services Providers

This appendix stipulates the technical criteria on the disclosure requirements for investment services licence holders. This appendix was amended in order to transpose the disclosure on own funds relating to hybrid capital stipulated in Directive 2009/111 and part of the requirements on remuneration policies set in Directive 2010/76.

All the above amendments to the Investment Services Rules for Investment Services Providers come into force on the date of this circular. However, with regards to the practical implementation, the rules which set requirements that necessitate a change to the financial return shall come into force on the date when the MFSA will issue the updated financial return.

Guidelines issued by the Committee of the European Banking Supervisors (CEBS)

Certain articles of the CRD, in particular Articles 63a (4) and (6) of Directive 2006/48/EC which relate to the features governing hybrid capital instruments, refer to the guidance which is elaborated by CEBS with the aim of achieving supervisory convergence between the EU Member States.

In this regard, the Authority has made reference to the guidelines issued by CEBS in the Investment Services Rules for Investment Services Providers, for the purposes of transposing the provisions of CRD II. Licence Holders may have access to these CEBS guidelines through the following link: http://www.c-ebs.org/Publications/Standards-Guidelines.aspx

Contacts:

Should you have any queries regarding the CRD II and part of the CRD III amendments, please do not hesitate to contact: Mr. Christopher P. Buttigieg, Deputy Director, Tel: 25485229 cbuttigieg@mfsa.com.mt or Ms. Mellyora Grech, Manager, Tel: 25485193 mgrech@mfsa.com.mt.

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