MFSA MALTA FINANCIAL SERVICES AUTHORITY

FINANCIAL INSTITUTIONS RULE FIR/02 SUPERVISORY AND REGULATORY REQUIREMENTS OF INSTITUTIONS AUTHORISED UNDER THE FINANCIAL INSTITUTIONS ACT 1994

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REVISIONS LOG

VERSION	DATE ISSUED	DETAILS
1.00	2011	Publishing of supervisory and regulatory requirements
2.00	2019	Amendments to incorporate transposition of Directive 2015/2366
3.00	2020	Amendment to paragraph 48 and the introduction of paragraph 48A regarding the MFSA Guidance on Technology Arrangements, ICT and Security Risk Management, and Outsourcing Arrangements.

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SUPERVISORY AND REGULATORY REQUIREMENTS OF INSTITUTIONS AUTHORISED UNDER THE FINANCIAL INSTITUTIONS ACT 1994

INTRODUCTION

1. In terms of Article 13(2) of the Financial Institutions Act 1994 ('the Act') the competent authority ('the Authority') as appointed under Article 3 of the Malta Financial Services Authority Act may make Financial Institutions Rules as may be required for the carrying into effect of any of the provisions of the Act. The Financial Institutions Rules and any amendment or revocation thereof shall be officially communicated to financial institutions and the Authority shall make copies thereof available to the public, through publication on the Authority's website.

2. The Supervisory and Regulatory Requirements of Institutions Authorised under the Financial Institutions Act 1994 Rule ('the Rule') is being issued in terms of Article 13(4) of the Act which empowers the Authority to provide for different regulatory requirements applicable to different classes of institutions. The requirements in the Rule are of a general nature and the Authority will apply particular requirements to specific classes of institutions as it deems appropriate through the licence.

3. The Rule also highlights the supervisory and investigative powers of the Authority as provided for in the Act. These highlights should not however be construed in any way to be a substitute for a reading of the relevant provisions of the Act itself. The responsibility for observing such provisions rests entirely with the financial institution, its Board of Directors and its management.

BUSINESS TO BE CONDUCTED IN A PRUDENT MANNER

4. Pursuant to Article 5(1)(d) of the Act, the Authority expects that a licensed institution conducts its business in a prudent manner.

5. Without prejudice to Article 5 of the Act and to the generality of consideration as to whether the business is being conducted prudently, a licensed financial institution shall not be regarded as conducting its business in a prudent manner unless:

(a) the directors include non-executive directors as the Authority considers appropriate having regard to the nature and scale of operations of the institution and who shall act in a control capacity in questioning the approach of the executive directors and other management;

(b) every person who is a director, controller, partner or any other officer of the institution is a fit and proper person to hold that particular position and to carry out business with integrity and skill. Without prejudice to Article 24 of the Act, in assessing whether a person has the relevant competence, soundness of judgement and diligence, the Authority considers the experience of similar responsibilities, qualifications and training;

(c) its officers take all reasonable steps to ensure that the institution, at all times, adapts itself to the requirements of the relevant Rules or regulations issued under the Act and the provisions of the Act itself;

(d) it makes adequate provisions for depreciation or diminution in the value of its assets, for liabilities which will or may fall to be discharged by it and for losses which it will or may incur. In assessing the adequacy of an institution's provisions, the Authority, where necessary, shall regard that institution's provisioning policies including, when applicable, the methods and systems for monitoring recoverability of loans and other advances and its policies and practices for the taking and valuation of security. In this respect, the Authority draws the attention of the institutions concerned to its notice on Management of Credit Risk (BN/01) and Banking Rule on Credit and Country Risk Provisioning (BR/09) issued to credit institutions in terms of the Banking Act 1994; and

(e) it maintains adequate accounting and other records and adequate systems of control of its business and records that are commensurate with its needs and particular circumstances in such a way as to enable the business of the institution to be prudently managed and for it to comply with the duties imposed on it by or under the Act. In assessing this adequacy, the Authority when appropriate, shall take into consideration the internal audit procedures of the institution.

SUPERVISORY REQUIREMENTS OF LICENSED INSTITUTIONS

6. The Authority places great importance to the timely and accurate reporting of statutory prudential statistical information by financial institutions. Such information, which is to be submitted in terms of Article 14 of the Act, is necessary for supervisory and regulatory reasons.

7. All financial institutions are subject to the Authority's continuing prudential supervisory

oversight under the Act and Rules. The Authority may conduct its supervision on an individual (solo) or consolidated basis taking account of the operations of banking and other financial companies connected to the licensed institutions always having regard to the individual structure and circumstances of each licensed institution.

8. The Authority can exercise its supervisory powers under Article 14 of the Act by appointing competent persons to investigate and report on the affairs of a financial institution. In this respect the Authority expects all officers of the institution to comply with the provisions of Articles 14, 15 and 16 of the Act.

PROHIBITED TRANSACTIONS

9. Licensed institutions and potential applicants for a licence under the Act are advised to read carefully Article 10 of the Act which restricts or prohibits certain transactions and to contact the Authority for any clarifications on such transactions where necessary.

REGULATORY REQUIREMENTS

10. As stated in paragraph 2 of the Rule, the Authority can provide for different regulatory requirements applicable to different classes of institutions. The subsequent paragraphs are intended to establish certain regulatory parameters which may be applied by the Authority on a case by case basis as it may deem appropriate in licensing an institution.

11. Certain services which can be provided by an institution licensed under the Act are similar to those carried out by a credit institution licensed under the Banking Act 1994. Therefore, in the Authority's opinion, institutions licensed to carry out such activities could be considered as quasi-banking institutions. Consequently, it would be prudent, for the safeguarding of the financial system that, to the extent necessary, such institutions are regulated on the same level as credit institutions, without being significantly bound by the provisions of the Banking Act 1994 whilst taking into consideration the fact that at law financial institutions are prohibited from funding their activities through deposits.

12. A financial institution which is a subsidiary of a credit institution or the parent undertaking of a credit institution or which is part of a group which also comprises a credit institution would, in the Authority's opinion, require to be regulated within the parameters of a credit institution itself. However, this does not mean that such a financial institution is in any way bound by the provisions of the Banking Act 1994.

13. A financial institution carrying out activities listed in the First Schedule to the Act which, although not requiring a licence under the Investment Services Act 1994, are very similar

to activities under that Act, may be required to be regulated within the parameters of the said Investment Services Act 1994. The extent to which such requirements will be applied to these institutions will be discussed and agreed by the Authority and the applicant for a licence. The Authority's decision in this respect would however be final.

14. Other institutions carrying out activities listed in the First Schedule to the Act which in the Authority's opinion could not be considered as similar to those institutions in paragraphs 11 or 13 above would require a prudential supervisory approach proportionate to the nature, scale and extent of such activities.

15. Consequent to the above, the regulatory requirements in the subsequent paragraphs (except paragraphs 21 to 24 and 36) reflect concepts within the respective prudential Banking Rules issued in terms of the Banking Act 1994. However, the Authority may apply particular sections of these Rules depending on the type and structure of the institution to be licensed.

LARGE EXPOSURES

16. In cognizance of the fact that in carrying out certain activities listed in the First Schedule to the Act, specifically activities listed under paragraphs 1, 2, 3 and 6, a financial institution would be committing itself in exposures with third parties, the Authority deems that such exposures should also be appropriately regulated to safeguard the financial system. In this respect the Authority would, where applicable, condition a licensed institution that undertakes such activities to the requirements of the Large Exposures Rule (BR/02) issued in terms of the Banking Act 1994.

17. The Authority recognises that the Large Exposures Rule (BR/02) cannot however be applied on an equal basis to all financial institutions. The Authority would thus apply a proportionality principle according to the nature, scale and extent of the activities.

18. In determining the measure up to which the Large Exposures Rule (BR/02) will be applied to a given institution, the Authority will take into consideration the following criteria:

(a) where the financial institution is a subsidiary of a credit institution, or the parent undertaking of a credit institution, or which is part of a group which also comprises a credit institution incorporated in Malta, the Authority may apply the Large Exposures Rule (BR/02) in full;

(b) where the financial institution is a stand-alone institution incorporated in Malta, the 25% single exposure limit as established in paragraph 25 of the Large

Exposures Rule (BR/02) is raised to 40% provided that the other limits established by the said Rule are adhered to;

(c) where an institution as in point (a) above is a branch of an overseas institution or forms part of an overseas banking group the Authority may, irrespective of paragraph 53 of the Large Exposures Rule (BR/02) either raise the 25% limit to 40% or, provided that other limits established by the said Rule are adhered to, agree with the overseas supervisory authority on appropriate limits.

OWN FUNDS

19. Since limits for large exposures are calculated against the Own Funds of an institution, where the Authority applies in whole or in part the Large Exposures Rule (BR/02) to an institution licensed under the Act that institution will automatically be bound by the requirements of the Own Funds Rule (BR/03) issued in terms of the Banking Act 1994.

20. The Authority expects that financial institutions, other than those referred to in paragraph 19 of this Rule, to adopt the Own Funds Rule (BR/03). In terms of Article 14 of the Act, the Authority may request such institutions to submit the computation of the institution's own funds as per Appendix 1 of the Own Funds Rule (BR/03). The initial own funds of an applicant institution will be set by the Authority on a case by case basis but in line with paragraph 37 of the Application Procedures and Requirements for Authorisation of Licences Rule (FIR/01), and will be commensurate with the activities set out in the business plan submitted by the prospective applicants.

21. In the case of a financial institution undertaking payment services in terms of the Second Schedule to the Act (hereinafter referred to as a payment institution), its own funds shall not fall below the amount of initial capital as referred to in paragraph 37 of FIR/01 or the amount of own funds as calculated in accordance with paragraphs 22 and 23 of this Rule, whichever is the higher. In the case of a financial institution issuing electronic money in terms of the Third Schedule to the Act, as indicated in paragraph 20 of FIR/03, its own funds may not fall below the amount of initial capital indicated in paragraphs 18 of FIR/03 as may be applicable or the calculation of own funds as set out in paragraphs 21 to 23 of FIR/03, whichever is the higher. When paragraph 24 of this Rule applies, additional own funds may be required by the Authority in the case of a financial institution that undertakes other activities in the First Schedule to the Act apart from activities listed under paragraph 4 or 10.

Where such a financial institution referred to in paragraph 21 above belongs to the same group as another financial institution undertaking payment services, credit institution, investment firm, asset management company or insurance undertaking, it may not make multiple use of elements eligible for own funds. This shall also apply where the

financial institution has a hybrid character and carries out activities other than providing payment services listed in the Second Schedule to the Act.

22. (1) Notwithstanding the initial capital requirements set out in paragraph 37 of FIR/01, payment institutions, except those offering only services as referred to in paragraph 2(g) or 2(h), or both, of the Second Schedule to the Act, are required to hold, at all times, own funds calculated in accordance with one of the following three methods, as determined by the Authority, on a case by case basis.

- METHOD A: The payment institution's own funds shall amount to at least 10% of its fixed overheads of the preceding year. In this regard, the Authority may adjust the required amount in the event of a material change in the payment institution's business since the preceding year. Where the payment institution has not completed a full year's business as at the date of calculation, its own funds shall amount to at least 10% of the corresponding fixed overheads as projected in its business plan, unless adjustment to that plan is required by the Authority.)

- METHOD B: The payment institution's own funds shall at least be equal to the sum of the following elements multiplied by the scaling factor k defined in paragraph 2, where the payment volume (PV) represents one twelfth of the total amount of payment transactions executed by the payment institution in the preceding year: -

  a) 4.0% of the slice of PV up to €5 million; plus
  b) 2.5% of the slice of PV above €5 million up to €10 million; plus
  c) 1% of the slice of PV above €10 million up to €100 million; plus
  d) 0.5% of the slice of PV above €100 million up to €250 million; plus
  e) 0.25% of the lice of PV above €250 million.

- METHOD C: The payment institution's own funds shall amount to at least the relevant indicator defined in point (a), multiplied by the multiplication factor defined in point (b), and by the scaling factor k defined in paragraph 2.

(a) the relevant indicator is the sum of the following:
  - interest income;
  - interest expenses;
  - commissions and fees received; and
  - other operating income.

Each element shall be included in the sum with its positive or negative sign. Income from extraordinary or irregular items shall not be used in the calculation of the relevant indicator. Expenditure on the outsourcing of services rendered by third parties may reduce the relevant indicator if the expenditure is incurred from an undertaking subject to supervision under this Rule. The relevant indicator is calculated on the basis of twelve-

monthly observation at the end of the previous financial year. The relevant indicator shall be calculated over the previous financial year. Nevertheless, own funds calculated according to Method C shall not fall below 80% of the average of the previous three financial years for the relevant indicator. When audited figures are not available, business estimates may be used.

(b) The multiplications factor shall be:

(i) 10% of the slice of the relevant indicator up to €2.5 million;
(ii) 8% of the slice of the relevant indicator from €2.5 million up to €5 million;
(iii) 6% of the slice of the relevant indicator from €5 million up to €25 million;
(iv) 3% of the slice of the relevant indicator from €25 million up to €50 million;
(v) 1.5% above €50 million.

(2) The scaling factor k to be used in methods B and C shall be:

a) 0.5 where the payment institution provides only the payment service as referred to in paragraph 2(f) of the Second Schedule to the Act;
b) 1 where the payment institution provides any of the payment services listed in paragraphs 2(a) to (e) of the Second Schedule to the Act.

23. The Authority may, based on an evaluation of a payment institution's risk-management processes, risk loss data base and internal control mechanisms, require on a case by case basis such payment institution to hold an amount of own funds which is up to 20% higher than the amount of own funds which would result from the application of the method chosen in accordance with paragraph 22 above, or permit it to hold an amount of own funds which is up to 20% lower than the amount which would result from the application of the method chosen in accordance with paragraph 22.

SOLVENCY RATIO

24. The Authority deems it appropriate to apply the Solvency Ratio Directive (BD/04) as may be necessary to financial institutions carrying out activities other than the activities listed under paragraphs 4 or 10 in the First Schedule to the Act. The Authority considers that the minimum own funds requirement stipulated in paragraphs 22 to 23 above or paragraphs 21 to 23 of FIR/03 would be sufficient for institutions carrying out only the activities listed under paragraphs 4 or 10 respectively. In the case of financial institutions that do not only carry out the activities listed under paragraphs 4 or 10 but undertake other activities in the First Schedule to the Act, where the Authority deems it appropriate to apply the Solvency Ratio Directive (BD/04), own funds requirements to meet the minimum level of the Solvency Ratio shall be in addition to minimum own funds requirements stipulated in paragraphs 22 to 23 above or paragraphs 21 to 23 of FIR/03.

In applying the Solvency Ratio Directive, the Authority will be guided by the reasons and criteria set out in paragraphs 16 to 18 of the Rule. Where BD/04 applies, the minimum level of the Solvency Ratio shall be set at 5%.

LIQUIDITY

25. The Authority recognises that the maintenance of continuous liquidity may be a determining factor for the prudential operation of a financial institution. The objectives of liquidity requirements under the Liquidity Rule (BR/05) issued in terms of the Banking Act 1994 are to safeguard the interests of depositors in case of unforeseen contingencies and to ensure that, at all times, the credit institution has sufficient assets to cover its liabilities.

26. By definition a financial institution would not therefore be required to maintain a liquid asset ratio to safeguard depositors. The Authority, however, emphasises the need for all financial institutions to maintain continuous liquidity to ensure that they have sufficient assets to cover their liabilities and to be able to meet their obligations as and when they fall due.

27. In this respect the Authority will apply the continuous liquidity requirements (Maturity Ladder) as defined in the Liquidity Rule (BR/05) as may be appropriate to financial institutions undertaking particular activities.

SUBMISSION OF PRUDENTIAL INFORMATION

28. Paragraph 20 of the Application Procedures and Requirements for Authorisation of Licences Rule (FIR/01) issued in terms of the Act establishes the necessity of adequate flows of information from the institution to the Authority as one of the minimum criteria for authorisation.

29. Although Article 14 of the Act does not stipulate particular statutory periodical information to be submitted by the licensed institutions, the Authority would require timely and accurate disclosure of certain information for prudential and supervisory reasons.

30. Considering the fact that various types of financial institutions may be authorised under the Act, the Authority cannot adopt a standard format for the submission of financial information. Consequently, these will be agreed to with particular institutions as part of the licensing procedure.

31. Notwithstanding paragraph 30 of the Rule, where appropriate to certain types of

institutions, the Authority would adopt the format as prescribed in the Appendices to the Statutory Financial Information Directive (BD/06) issued in terms of the Banking Act 1994.

AUDITED FINANCIAL STATEMENTS

32. The Companies Act 1995 (Article 168) exempts financial institutions authorised under the Act from applying the provisions of the Third and Fourth Schedules of the Companies Act 1995 in publishing their annual accounts. However, it requires financial institutions to follow any Banking Rules and Financial Institutions Rules issued by the Authority under the Banking Act and the Financial Institutions Act, respectively, in relation to the form and content of their annual accounts and any other Rules issued by the Authority in this regard.

33. In this respect, the Authority expects financial institutions to be guided by the Rule on the Publication of Audited Financial Statements (BR/07) issued in terms of the Banking Act 1994 as may be applicable and in a manner proportionate to a financial institution's legal status.

34. The requirement under paragraph 33 above will be stipulated in the institution's operating licence.

35. Paragraph (e) of paragraph 5 of this Rule requires an institution to maintain adequate accounting and other records as a prerequisite for business to be considered as being conducted in a prudent manner. The Authority therefore requires all institutions authorised under the Act to file with it a copy of their annual audited financial statements within four months from the end of their financial year. These financial statements are to be accompanied by a detailed breakdown of income and expense items featuring in the profit and loss account and the auditors' management letter accompanied by the related replies from the financial institutions themselves.

36. Where deemed necessary and without prejudice to the provisions of Article 5(6) of the Act, the Authority may require financial institutions which are members of a non-banking financial or a non-financial group of companies to submit their annual audited consolidated financial statements together with audited financial statements for each company forming part of such group of companies. For the purposes of this Article, a group of companies shall have the same meaning as is construed by the term "group" in the definition of "group company" in the Companies Act, 1995. Likewise, the term "consolidated financial statements" shall refer to the "consolidated accounts" required by Article 170 of the Companies Act, 1995 but, for the purposes of this Rule, the financial institution need not necessarily be the parent company of the group of companies of which it is a member.

37. Consequent to Article 18 of the Act, the Authority expects that all financial statements (annual accounts) submitted under paragraphs 35 and 36 of the Rule are certified by the institution's Auditor as giving a true and fair view of that institution's assets and liabilities and financial position.

CREDIT AND COUNTRY RISK PROVISIONING

38A. The Authority considers Banking Rule BR/09 on Credit and Country Risk Provisioning by Credit Institutions as being relevant for the prudential supervision of certain types of financial institutions. Paragraph 3 of this Rule states that it is intended not only for loans and advances or credit facilities but also for any other unlisted debt instruments such as securities and similar instruments.

38B. Consequently, the Authority will apply this Rule to financial institutions, particularly those undertaking activities listed under paragraphs 1, 2, 3 and 6 of the First Schedule to the Act at the licensing stage and on an on-going basis as applicable in relation to the latter's' licensed activities.

CONSOLIDATED SUPERVISION

38C. Financial institutions that are subsidiaries of credit institutions or which form part of a banking group (as defined in Banking Rule BR/10) are by definition included in the consolidated supervision of credit institutions in terms of paragraph 6 of Banking Rule BR/10 on the Supervision on a Consolidated Basis of Credit Institutions.

38D. The Authority will apply Banking Rule BR/10 on the Supervision on a Consolidated Basis of Credit Institutions, as it deems appropriate, to financial institutions that form part of a non-banking financial group of companies that includes undertakings referred to in paragraph 6 of the Rule.

38E. The Authority will likewise apply the principles of consolidated supervision included in Banking Rule BR/10 on the Supervision on a Consolidated Basis of Credit Institutions to financial institutions that form part of a non-financial group of companies as the Authority deems opportune. The Authority will do so in relation to the qualitative and quantitative principles that are established in the foregoing Banking Rule BR/10.

38F. In evaluating the qualitative aspect, the Authority will take into consideration the stability and prudent management of the financial institution. As to its evaluation of the quantitative aspect, the Authority will take into full consideration the contents of relevant financial information that a financial institution forming part of a non-financial

group of companies will be required to submit in terms of paragraph 36 and as the Authority may deem necessary from time to time.

OTHER REQUIREMENTS

39. Notwithstanding paragraphs 16 to 38F above, and given that in terms of sub-article (4) of Article 5 of the Act, an institution authorised under the Act can be subjected to other conditions as the Authority may deem appropriate, the Authority reserves the right to establish other regulatory requirements to particular classes of institutions.

40. Such other regulatory requirements will vary according to the type or class of institutions to be licensed. However, the Authority will not apply different measures of regulatory requirements to institutions falling within the same type or class unless it is appropriate in the circumstances.

41. The Authority will discuss these other requirements with the applicant and will include them in the licence.

ARMS LENGTH PRINCIPLE

42. The Authority considers Banking Rule BR/11 on the Extension of the Applicability of the "Arm's Length" Principle by Credit Institutions Authorised under the Banking Act 1994 as being relevant to financial institutions since it deals with categories of connected persons.

43. The extent to which financial institutions are to apply the principle is currently established in paragraph (b) of Article 10(1) of the Act, which lists the categories of persons in respect of which the principle is to be applied ("the connected persons").

44. Furthermore the same paragraph (b) of Article 10(1) of the Act empowers the Authority to take measures to ensure compliance by financial institutions with this provision.

PRUDENTIAL ASSESSMENT OF ACQUISITIONS AND INCREASE IN SHAREHOLDINGS

45. According to Article 9(1) of the Act, any person who intends to acquire or dispose or vary its participation or control in a financial institution within the parameters set in the said Article, has to obtain the prior approval of the Authority.

46. The Authority would be guided by the criteria laid down in Banking Rule BR/13 on the Prudential Assessment of Acquisitions and Increase in Shareholdings in assessing a proposed acquirer.

OUTSOURCING

47. Article 8B of the Act allows for the outsourcing of operational functions by financial institutions. It also provides that institutions shall inform the Authority when they intend to outsource operational functions, and that outsourcing of operational functions shall not be undertaken in a way that materially impairs the institution's internal control and the Authority's ability to monitor the institution's compliance with its obligations. The Act also lays out the conditions with which financial institutions shall comply when outsourcing important operational functions. In particular, Article 8B(3) of the Act provides for the issuing of a rule laying down the requirements for the outsourcing service providers and the provision of such outsourced services.

48. Following the above, reference is to be made to Banking Rule BR/14 on Outsourcing which outlines the general principles regulating the conduct of outsourcing. Financial institutions shall also, taking into account their size, nature, scale and complexity and on a best effort basis, refer to the Guidance on Technology Arrangements, ICT and Security Risk Management, and Outsourcing Arrangements.

ICT AND SECURITY RISK

48A. Payment services providers, as defined in Article 2(1) of the Act, shall comply with the provisions set out in the EBA Guidelines on ICT and security risk management (EBA/GL/2019/04), which specify how credit institutions shall manage the ICT and security risks that they are exposed to. Financial institutions shall also, taking into account their size, nature, scale and complexity and on a best effort basis, refer to the Guidance on Technology Arrangements, ICT and Security Risk Management, and Outsourcing Arrangements.

THE AUTHORITY TO TAKE CONTROL OF FINANCIAL INSTITUTIONS

49. The control of a financial institution may be taken over by the Authority should any of the circumstances indicated in sub-article (1) of Article 6 of the Act apply.

50. In this respect, authorised institutions and potential applicants are advised to consider carefully Articles 6(1), 11 and 17 of the Act and, if necessary, take legal advice.

ADMINISTRATIVE PENALTIES

51. Any person who breaches any of the provisions of this Rule as provided for under Article 23(1) of the Act, is liable to the penalties provided for under the said sub-article.

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