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Consultation Document

Consultation on the revised methodology for the identification of other systemically important institutions (O-SIIs) and the related capital buffer calibration

25 October 2019

Closing Date: 8 November 2019

Note: The documents circulated by the CBM & the MFSA for the purposes of consultation are in draft form and consist of proposals. Accordingly, these are not binding and are subject to changes and revisions following representations received from License Holders and other interested parties. It is important that persons involved in the consultation process bear these considerations in mind.

Executive summary

The aim of this document is to consult on the review of the existing other systemically important institutions framework (O-SII framework), which amongst others proposes a change in the methodology to bring it more in line with the European Banking Authority (EBA) Guidelines on the criteria to assess other systemically important institutions (O-SIIs).

The CRRII/CRDV framework requires the identification of systemically important institutions and the setting up of corresponding capital buffers, known as the O-SII buffer, to enhance the loss absorbing capacity of such institutions and hence limit the propagation of risk onto the domestic financial system. Thus, the aim of this macroprudential measure is to further strengthen the system from institution-specific (including moral hazard) and sector-wide shocks.

The implementation of the framework for an O-SII buffer as per Article 131 CRDV involves: (a) a methodology for the identification of institutions as O-SIIs; and (b) a methodology for the calibration of the buffer rate which will be applied to identified O-SIIs.

On 1 January 2016, the Central Bank of Malta (CBM) jointly with the Malta Financial Services Authority (MFSA) - the Authorities - introduced for the first time a 'Policy Document' on the identification of O-SIIs and the calibration of the related capital buffer.

Within the scope of the identification methodology adopted by the Authorities through the Joint Financial Stability Board (JFSB) and in line with the then CRDIV Article 131, as a first step, systemically important institutions are to be identified and assessed on the basis of their relative importance within the sector based on a set of specific criteria. The higher the resultant score, the more important the institution is within the sector, reflecting greater risk posed to the domestic financial system and real economy in case of failure of the institution. In a second step, the Authorities assess whether further institutions should be designated as O-SIIs based on additional indicators. Meanwhile, the calibration stage is based on the scores obtained during the identification stage.

The proposed new methodology, similar to the existing one, also identifies domestic systemically important institutions based on their relative importance within the sector as per a set of specific criteria. The proposed categories and indicators are based on those put forward in the EBA Guidelines. However, additional indicators have been included to account for the specificities of the domestic financial sector.

The proposed new methodology encompasses the identification criteria for an O-SII on the basis of a pre-determined threshold, established in accordance with the EBA Guidelines. If an institution's overall weighted average score is equal to or above this given threshold, such institution will be classified as an O-SII. Furthermore, based on the level of the scores exceeding the threshold, O-SIIs will be allocated to different buckets attracting different buffer rates; the O-SIIs with the highest scores will be allocated to the higher buckets while the O-SIIs with the lowest scores will be allocated to the lower buckets, subject to pre-determined thresholds and criteria (Refer to Annex 3).

This consultation will run until 8 November 2019, with the proposed framework envisaged to come into force by 1 January 2020.

1.0 Introduction

The CRDV¹/CRRII² framework provides the legal background for the identification of systemically important institutions in EU Member States (Article 131 CRDV – ‘Global and other systemically important institutions’). Pursuant to regulation 2(2) of the Central Bank of Malta Act (Appointment of Designate Authority to implement Macro-Prudential Instruments) Regulations (S.L. 204.06 of the Laws of Malta), the responsibility for the domestic implementation of this Article is shared jointly between the Central Bank of Malta (CBM) and the Malta Financial Services Authority (MFSA) (hereinafter referred to as ‘the Authorities’).

The other systemically important institutions buffer (O-SII buffer) consists of a capital surcharge applied to institutions that may, in the event of failure or impairment, have considerable impact on the financial system and the real economy. This additional capital buffer is applied to domestic systemically important institutions to increase their resilience by increasing their loss absorbing capacity and thereby ensuring that they pose minimal risk to the domestic economy in the form of externalities. Market failures targeted by the O-SII buffer mainly relate to the excessive risk-taking due to expectations of a bailout as a result of the perceived systemic relevance of an individual institution (moral hazard and 'too big to fail'). In this respect, the O-SII buffer is a macro-prudential instrument that contributes to the development of financial stability by mitigating the structural element of systemic risk stemming from moral hazard, thereby promoting market discipline.

The O-SII buffer is an essential element of the ESRB Recommendation on the intermediate objectives and instruments of macro-prudential policy³, and is a macro-prudential tool legally embedded in the CRDV/CRRII framework which, in turn, is domestically transposed in CBM Directive No. 11⁴ and MFSA Banking Rule No. 15⁵.

In line with the then CRDIV/CRR framework, on 1 January 2016, the Authorities, introduced for the first time a Policy Document on the identification of O-SIIs and the calibration of the related capital buffer (hereinafter referred to as the ‘2016 O-SII methodology’). The measure has been introduced with the aim of increasing the loss-absorbing capacity of institutions that are deemed to be of high systemic relevance.

¹ Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending the Capital Requirements Directive IV as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

² Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending the Capital Requirements Regulation as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements.

³ Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1).

https://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB_2013_1.en.pdf

⁴ Directive No. 11 – Macro-prudential Policy.

⁵ BR/15/2015 Capital Buffers of Credit Institutions Authorised under the Banking Act 1994.

Following a public consultation on the methodology for the identification of O-SIIs and the related capital buffer calibration in 2016, the Authorities introduced a framework which reflected more the domestic specificities of the Maltese banking sector.⁶ While the domestic framework essentially deviated from the European Banking Authority (EBA) Guidelines (EBA/GL/2014/10) (hereinafter referred to as the 'EBA Guidelines')⁷, this was still in line with the Basel Committee on Banking Supervision (BCBS) Guidelines.⁸ The motivation for deviating from the EBA Guidelines essentially reflects the fact that given the structure of the banking sector in Malta at the time, the EBA methodology was capturing as O-SIIs a number of banks licensed in Malta, which however exhibited limited systemic relevance to the domestic economy.

The 2016 O-SII methodology was based on a two-stepped approach. As a first step, the Authorities assessed systemically important institutions on the basis of their relevance within the domestic financial sector based on the following criteria: (i) size, (ii) substitutability, (iii) cross border activity and (iv) resident interconnectedness, on the basis of a system of z-scoring. Institutions with an overall result exceeding the value of 1, i.e. beyond one standard deviation from the mean, were classified as O-SIIs based on the above-mentioned criteria.

The 2016 O-SII identification methodology also included a second step whereby authorities assessed whether further institutions should be designated as O-SIIs based on two additional indicators:

1. Size \geq 25% of GDP; and
2. Covered Deposits \geq 2.5 times the domestic Depositor Compensation Scheme (DCS) funding.

Irrespective of the first step, an institution that meets both criteria listed in points 1 and 2 above would still be subject to an O-SII capital buffer.

The Authorities periodically assess the methodology and during the 2019's iteration, decided to revise and update the 2016 O-SII Methodology. The objectives behind this revision are to better reflect the developments in the domestic financial sector and also to further align the domestic O-SII methodology with the EBA Guidelines, with a view to implement the revised methodology as from 1 January 2020.

This consultation paper proposes a new framework for the O-SII identification methodology. Firstly, section 2.0 outlines the entities which can be designated as O-SIIs. Following a reassessment of the EBA methodology, the latter is now deemed more suitable in terms of the plausibility of its results in the current local context. For this reason, the consultation paper proposes that the new methodology is based on the EBA Guidelines. In essence this entails the adoption of the mandatory indicators stipulated in the EBA Guidelines, as well as the addition of other indicators (listed as optional indicators under step 2 of the EBA Guidelines) which are deemed to better reflect the specificities of

⁶ MFSA CBM policy document Policy Document on the methodology for the identification of other systemically important institutions and the related capital buffer calibration –

<https://www.centralbankmalta.org/systemically-important-institutions>

⁷ [EBA/GL/2014/10](#) On the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs).

⁸ [A framework for dealing with domestic systemically important banks](#), October 2012, Bank for International Settlements.

the domestic financial sector - discussed in more detail in Section 3.0. In addition to the identification methodology, the proposed framework also outlines a bucketing approach as part of the O-SII calibration process which will then be used to calibrate the O-SII capital buffer rate, - discussed in section 4.0. Section 5.0 outlines the transitional provisions while section 6.0 provides stakeholders with details on responses to the consultation and next steps.

2.0 Entities that can be identified as O-SIIs

In line with Article 131 of the CRDV, the O-SII framework outlined in this consultation document is to be applied to all entities subject to the CRDV/CRRII on an individual, sub-consolidated or consolidated basis, as applicable. Identified O-SIIs will be required to hold an O-SII buffer at the highest level of consolidation in Malta.

3.0 Proposed methodology for O-SII identification

Step 1

O-SIIs will be identified in line with the EBA Guidelines based on a core set of criteria (categories), indicators and weights as per table 1. Annex 1 outlines the rationale for selecting the indicators of domestic relevance listed in table 1.

Table 1: Scoring Methodology for domestic O-SII identification

Category	Indicators	Indicator weight	Category weights
Size	Total Assets	22.00%	22.00%
Importance	Value of domestic payment transactions	8.00%	40.00%
	Private sector deposits from depositors in the EU*	5.50%	
	Private sector loans to recipients in the EU**	5.50%	
	Private sector deposits from Maltese residents	10.50%	
	Private sector loans to Maltese residents	10.50%	
Complexity	Value of OTC derivatives (notional)	4.00%	18.00%
	Cross-jurisdictional liabilities	7.00%	
	Cross-jurisdictional claims	7.00%	
Interconnectedness	Intra-financial system liabilities	9.00%	20.00%
	Intra-financial system assets	9.00%	
	Debt securities outstanding	2.00%	

* MT deposits are incorporated in 'private sector deposits from depositors in the EU' indicator.

** MT loans are incorporated in 'private sector loans to recipients in the EU' indicator.

In line with the EBA Guidelines, the Authorities will calculate the score in basis points (bps) for domestic institutions by:

- (a) dividing the indicator value of each individual relevant entity by the aggregate amount of the respective indicator values summed across all domestic institutions (the 'denominators');
- (b) multiplying the resulting percentages by 10 000 to express the indicator scores in terms of basis points;
- (c) calculating the category score for each relevant entity by taking a weighted average of the indicator scores in that category;
- (d) calculating the overall score for each relevant entity by taking a weighted average of its four category scores.

As per EBA Guidelines, institutions with a score equal to or higher than 350 bps should be designated as O-SIIs. However, the EBA Guidelines also allow for a +/- 75 bps leeway to either increase the maximum threshold to 425 bps or decrease the minimum threshold to 275 bps. The proposed revised identification methodology establishes the cut-off threshold point at 425 bps to reflect Malta's relatively small financial sector and high concentration levels due to a small number of market participants.

Step 2

The EBA Guidelines put forward a number of optional indicators which Member States may adopt to complement the initial set of indicators to reflect the specificities of each national financial sector. In this regard, the Authorities have assessed a number of optional indicators under step 2 of the EBA Guidelines and decided to incorporate 'Private Sector Deposits from Maltese residents' and 'Private Sector Loans to Maltese residents' as indicators under the 'Importance' category. These additional indicators have been incorporated in the 'Importance' category to account for the specificities of the Maltese financial sector; in particular, the strong orientation towards domestic deposits and loans.

Annex 2 illustrates a worked example showing the scores for four hypothetical banks (in basis points). The results show the scores for each category, inclusive of the proposed additional indicators and the resultant overall weighted average scores. To note, that the example provided is based on hypothetical data and should therefore not be seen as reflecting the scores of any specific credit institution/s.

Annex 3 provides a comparison between the 2016 O-SII methodology and the proposed revised methodology.

4.0 Capital buffer calibration

The identification methodology outlines the degree of systemic risk exerted by a particular O-SII. Credit institutions identified as O-SIIs, as per identification methodology proposed in section 3.0, will be required to maintain an applicable capital buffer, which shall consist of and shall be supplementary to Common Equity Tier 1 capital as a percentage of the total risk exposure amount. In view of this, the proposed bucketing methodology (table 2) is based on the scores achieved in the O-SII identification stage in section 3.0, and is described in detail hereunder:⁹

1. An O-SII can be classified into one of any of the five buckets presented in Table 2, depending on the O-SII score obtained with the identification methodology. Bucket 1 contains the lowest capital rate (0.25%) and bucket 5 entails the highest capital buffer rate (2.0%);
2. Intermediate buffer rates of 0.5%, 1.0% and 1.5% are also applicable, thus reinforcing a proportionate and commensurate application of an O-SII surcharge; the higher the systemic risk posed by the respective O-SII, the higher the capital buffer rate applied;
3. The overall score obtained in the identification methodology (refer to section 3.0) is used to indicate the bucket in which an institution is allocated, starting from the lowest bucket (bucket 1) as per below:

Table 2: Proposed O-SII bucketing methodology

Buckets	Capital Buffer Rate	Score range for each bucket (bps)
5	2.00%	$1700 \leq \text{Score}$
4	1.50%	$1200 \leq \text{Score} < 1700$
3	1.00%	$830 \leq \text{Score} < 1200$
2	0.50%	$580 \leq \text{Score} < 830$
1	0.25%	$425 \leq \text{Score} < 580$

5.0 Transitory provisions

The Authorities recognise the impact that certain provisions of the measure could have on a credit institution's capital planning. In view of this, the Authorities are hereby granting a transitory period until 1 January 2022 for the build-up of the O-SII buffer for newly identified O-SIIs. In addition, for those institutions currently classified as O-SIIs as per the 2016 O-SII methodology, and which may face a higher O-SII surcharge under the newly proposed O-SII methodology, only the difference between the current capital buffer rate, held by the respective O-SIIs, and the revised capital buffer rate resulting from the new O-SII methodology, will be subject to the transitory period.

⁹ CRDV Article 131 para 5 states that the relevant authorities may require each O-SII, on a consolidated or sub-consolidated or individual basis, as applicable, to maintain an O-SII buffer of up to 3% of the total risk exposure amount calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013, taking into account the criteria for the identification of the O-SII.

6.0 Responses and next steps

The CBM and the MFSA under the auspices of the JFSB are publishing this consultation paper inviting interested stakeholders to provide feedback by not later than noon of 8 November 2019.

Following this consultation period, the capital buffer rates for designated O-SIIs would be applicable as from 1 January 2020. Going forward, the Authorities will periodically review this proposed methodology and carry out revisions as necessary.

Any enquiries which institutions may have in this regard should be forwarded to both the CBM and MFSA via the following contact persons:

CBM:

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Annex 1: Selection of Indicators

The proposed categories and indicators are based on those put forward in the EBA Guidelines. Additional indicators have been included so as to take into account the specificities of the domestic financial sector. An outline of the four categories and the respective indicators under each category is provided below, together with the rationale for their inclusion.

Size

An indicator of total assets is used to measure the size of the credit institution within the sector. The larger the institution, the more difficult it is for its activities to be quickly replaced by other institutions and as a result, the greater the chance that its distress or failure would cause disruption to the financial markets in which it operates. The distress or failure of a large institution is also more likely to damage confidence in the financial system as a whole. Total assets, which is the indicator used to represent size, is therefore a key indicator of systemic importance.

Importance

The second category measures the importance of each institution vis-à-vis the others, i.e. the extent to which an institution provides financial-institution infrastructure in comparison with other institutions. In addition to 'value of domestic payment transactions', 'private sector deposits from depositors in the EU', and 'private sector loans to recipients in the EU' indicators which are mandatory in the EBA Guidelines, two more additional indicators are proposed. These additional indicators are; (i) 'private sector deposits from Maltese residents' and (ii) 'private sector loans to Maltese residents'. The rationale for the latter two indicators is that given the structure and characteristics of the Maltese financial sector, domestic loans and deposits are deemed as key indicators for gauging domestic systemic significance. All of the five indicators showcase the importance of an institution. The more important and un-substitutable an institution is, the greater the risk of moral hazard and negative impacts on the real economy in an adverse scenario.

Complexity

Complexity of an institution can be described as the complexity of the resolution process, which could be evaluated through the importance of market activity. In order to quantify this category, three indicators are selected: (i) the value of over-the-counter (OTC) derivatives; (ii) cross-jurisdiction liabilities; and (iii) cross-jurisdiction assets.

Interconnectedness

The last category relates to the interconnectedness of an institution which is measured as the institution's impact on the financial system of a Member State, considering the materiality of the threat that failure of the institution might have a considerable negative impact on other participants of the financial sector and in turn the real economy. Three sets of indicators are used to assess the interconnectedness of an institution: (i) intra-financial system liabilities, (ii) intra-financial system assets, and (iii) debt securities outstanding.

Annex 2: Worked example

	Bank A	Bank B	Bank C	Bank D
	Score in basis points	Score in basis points	Score in basis points	Score in basis points
Size				
Total Assets	400	150	2500	1200
Importance				
Value of domestic payment transactions	35	40	1500	600
Private sector deposits from depositors in the EU	750	250	3500	1500
Private sector loans to recipients in the EU	1000	300	3500	2000
Private sector deposits from Maltese residents	600	350	4500	2200
Private sector loans to Maltese residents	1000	500	4000	3000
Complexity				
Value of OTC derivatives	0	0	80	900
Cross-jurisdiction liabilities	150	200	600	300
Cross-jurisdiction claims	130	80	1300	280
Interconnectedness				
Intra-financial system liabilities	120	20	800	200
Intra-financial system assets	200	160	1800	700
Debt securities outstanding	0	0	5000	0
Calculation of Weighted Category Scores				
Size	400	150	2500	1200
Importance	668	307	3494	1966
Complexity	109	109	757	426
Interconnectedness	144	81	1670	405
Overall Weighted Averages				
	404	192	2418*	1208*
Buffer Calibration				
Applicable Buffer Rate	0%	0%	2%	1.5%

Overall weighted average = (size × 22%) + (importance × 40%) + (complexity × 18%) + (interconnectedness × 20%)

*Exceeds 425 basis points threshold

Annex 3: Comparison between the 2016 O-SII identification methodology and the proposed Revised Methodology

2016 O-SII Methodology				Revised O-SII Methodology			
Criteria	Indicators	Weight		Criteria	Indicators	Weight	
Size	Total Assets	20.00%	20%	Size	Total assets	22.00%	22%
Substitutability	Resident customer loans	13.33%	40%	Importance	Value of domestic payment transactions	8.00%	40%
	Resident customer deposits	13.33%			Private sector deposits from depositors in the EU	5.50%	
	Holdings of Government debt	13.33%			Private sector loans to recipients in the EU	5.50%	
		Private sector deposits from Maltese residents	10.50%				
			Private sector loans to Maltese residents		10.50%		
Cross-Border Activity	Cross-border assets	10.00%	20%	Complexity	Value of OTC derivatives (notional)	4.00%	18%
	Cross-border liabilities	10.00%			Cross-jurisdictional liabilities	7.00%	
					Cross-jurisdictional claims	7.00%	
Resident Interconnectedness	Resident Interbank assets	10.00%	20%	Interconnectedness	Intra-financial system liabilities	9.00%	20%
	Resident Interbank liabilities	10.00%			Intra-financial system assets	9.00%	
			Debt securities outstanding		2.00%		
Scoring System		Weighted average - Z-scoring		Scoring System		Weighted Average - Basis points	
Identification criteria		Step 1 - Standard deviation from the mean ≥ 1		Identification criteria		Overall score ≥ 425 basis points	
		Step 2 - 1. Size $\geq 25\%$ of domestic GDP; and 2. Covered Deposits ≥ 2.5 times the domestic Depositor Compensation Scheme (DCS) funding					
Calibration	4 Buckets	Exceed Step 2 thresholds	0.5% Capital buffer	Calibration	5 buckets	425 \leq Score < 580	0.25% Capital buffer
		1 \leq Score < 1.25	1.0% Capital buffer			580 \leq Score < 830	0.5% Capital buffer
		1.25 \leq Score < 1.75	1.5% Capital buffer			830 \leq Score < 1200	1.0% Capital buffer
		1.75 \leq Score	2.0% Capital buffer			1200 \leq Score < 1700	1.5% Capital buffer
						1700 \leq Score	2.0% Capital buffer