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MFSA MALTA FINANCIAL SERVICES AUTHORITY

Feedback Statement to stakeholder responses on the joint consultation on the revised methodology for the identification of other systemically important institutions (O-SIIs) and the related capital buffer calibration issued on 25th October 2019

January 2020

1. Introduction

On 25th October 2019, the Central Bank of Malta (CBM) in conjunction with the Malta Financial Services Authority (MFSA) (hereinafter referred to as 'the Authorities') launched a joint consultation on a revised methodology for the identification of other systemically important institutions (O-SIIs) and the related capital buffer calibration, in line with Article 131 of the CRDV[1]. The consultation was launched on the 25th October 2019 and concluded on 8th November 2019.

This document presents an account of the revised O-SII methodology in section 2, followed by a report on the feedback received from stakeholders and the corresponding replies of the Authorities in section 3. The document concludes by outlining the way forward set by the Authorities on the final decision of the designation of O-SIIs in section 4.

2. Overview of the revised O-SII methodology

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 the domestic specificities of the Maltese banking sector.[2] In 2019, the Authorities decided to revise the 2016 O-SII Methodology so as to better reflect the developments in the domestic financial sector and, to further align the domestic O-SII methodology with the EBA Guidelines.[3]

[1] It is to be noted that the provisions of the CRDV/CRRII referred to in this Feedback Statement would come into effect from 29 December 2020 / 28 June 2021.

[2] CBM-MFSA policy document on the methodology for the identification of other systemically important institutions and the related capital buffer calibration: https://centralbank-frontend.staging.dd.com.mt/file.aspx?f=261803

[3] 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). https://eba.europa.eu/sites/default/documents/files/documents/10180/930752/964fa8c7-6f7c-431a-8c34-82d42d112d91/EBA-GL-2014-10%20(Guidelines%20on%20O-SIIs%20Assessment).pdf

2.1 Revised methodology for O-SII identification

Under the revised methodology, O-SIIs will be identified based on the EBA Guidelines encompassing a core set of categories, indicators and weights as highlighted 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.

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 decided to incorporate two additional indicators; 'Private Sector Deposits from Maltese residents' and 'Private Sector Loans to Maltese residents'. 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.

As per the EBA Guidelines, institutions with a score equal to or higher than 350 bps would be automatically designated as O-SIIs. However, the EBA Guidelines also allow for a +/- 75 bps leeway to either increase the threshold to 425 bps or decrease the threshold to 275 bps to reflect the specificities of Member States' banking sectors. To this end, the Authorities also decided to set the cut-off threshold point at 425 bps (in line with the maximum leeway established in the EBA Guidelines) to reflect the relatively small Maltese financial sector and high concentration levels due to the small number of market participants, thereby avoiding an unduly capture of smaller credit institutions which are not effectively O-SIIs.

2.2 Revised Capital Buffer calibration

A bucketing methodology will be employed as part of the calibration stage based on the scores achieved in the O-SII identification stage. An institution identified as O-SII will be classified into one of any of the five buckets presented in Table 2, depending on the O-SII score obtained on the basis of the identification methodology (refer to Section 2.1). Bucket 1 contains the lowest capital rate (0.25%) whilst bucket 5 entails the highest capital buffer rate (2.0%).

Table 2: Revised O-SII bucketing methodology

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

3. Summary of the feedback received

This section outlines the feedback received from stakeholders in response to the public consultation, together with the Authorities' replies. Any changes which the Authorities deemed necessary have been incorporated in the final O-SII policy document.

3.1 Interplay between O-SII capital buffer and the minimum requirement for own funds and eligible liabilities (MREL) requirements

3.1.1 Feedback received

A respondent opined that there exist similarities between the nature and purpose of the O-SII capital buffer and the MREL requirements.[4] The respondent asked for greater clarity on why these two requirements should not be considered as overlapping since in the respondent's view, both requirements aim to safeguard the local economy in case of a bank failure.

[4] The BRRD requires banks to meet a minimum requirement of own funds and eligible liabilities (MREL) to allow banks to absorb losses and restore their capital position in case of failure, thereby allowing banks to continuously perform their critical economic functions during and after a crisis.

3.1.2 Authorities' Reply

The Authorities deem that the O-SII framework as per Article 131 of CRDV and the MREL framework in the Bank Resolution and Recovery Directive[5], have commonalities but serve different purposes. They share commonalities in the sense that they are both established to increase the resilience of those banks that are deemed as being too-big-to-fail. However, despite being motivated by the same problem, the two frameworks are based on different criteria; applied by separate authorities; used in different stages of a bank's lifetime and most importantly, have different objectives. Thus, rather than being overlapping, they are complementary to, and reinforce each other, and should therefore be seen in a wider context.

Reference is also made to the <u>BCBS' Global systemically important banks: assessment methodology and the additional loss absorbency requirement</u> which is addressed to Global Systemically Important Banks (G-SIBs) (but the concepts also apply to O-SIIs) and explains the interplay between the two frameworks as follows:

'Because there is no single solution to the externalities posed by G-SIBs, the official community is addressing the issue through a multipronged approach. The broad aim of the policies is to reduce:

- *the probability of failure of G-SIBs by increasing their going-concern loss absorbency; and*
- *the extent or impact of failure of G-SIBs, by improving global recovery and resolution frameworks'*

The Authorities also assess that MREL requirements are in place to ensure that even after bank failure, the bank has sufficient internal resources to recapitalise itself (bail-in). However, bank resolution is a complex and costly process and it would be desirable to avoid in the first place – not least due to potential impacts on investor and depositor confidence. This is where the O-SII buffer comes into play. While the buffers as per MREL requirements are tapped into and released *after* the failure of a bank i.e. it is a gone-concern buffer, the O-SII is a going-concern buffer and its aim is that of increasing the loss absorption capacity of the bank through the increased available CET1, thereby making the respective bank more resilient and less prone to failure. It can therefore be said that O-SII buffers reduce the probability of bank failure, while MREL buffers minimize the costs in case a bank fails.

[5] Directive 2014/59/EU of the European Parliament and of the council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN

As indicated, the O-SII buffer and MREL buffer are based on different criteria. MREL buffers (in particular the Recapitalisation Amount or 'RCA') are required when the Resolution Authority deems (amongst others) that a bank exercises critical functions i.e. the bank provides certain services which are important to the macroeconomic environment in which it operates and any disruption to these services (as a result of bank failure) would lead to a severe disturbance in the real economy. On the other hand, the O-SII buffer, through the revised O-SII identification methodology, applies to those banks which meet the set criteria and consequently are designated as O-SIIs. The criteria are chosen in such a way to reflect those elements and channels through which a large bank domiciled in Malta is most likely to pose systemic risk – the larger the systemic risk, the larger the O-SII score obtained and therefore the more preferable it would be to avoid the failure of the bank in question (reflected through a commensurately higher O-SII buffer for enhanced bank resilience).

Finally, the instruments which can be used for meeting these two different requirements continue to reinforce their stated purposes and objectives. The O-SII buffer is to be met by CET1 instruments and thus, the buffer can be exhausted in times of stress, without the bank necessarily failing, and can be then replenished once the time of stress weathers away.[6] The MREL buffer can also be met with subordinated liabilities, and is only made available for conversion to CET1 instruments once the bank has been deemed as failing or likely to fail (FOLTF).

Therefore, the Authorities deem that the O-SII capital buffer is just one measure from a broader toolkit whose function is to have in place a robust and resilient financial system. This toolkit includes the use of Combined Buffer Requirements, and enhanced Pillar 1 and Pillar 2 supervisory requirements, which are addressed at reducing the probability of bank failure. The resolution framework comes into play when these prudential requirements have proven to be insufficient to avoid bank failure.

3.2 Data to be used for identification stage

3.2.1 Feedback Received

Queries were received in relation to the data required for the Authorities to benchmark the institutions and in turn to derive the scoring, and whether this may be sourced directly by data already submitted to the MFSA or whether banks will be required to participate in a separate exercise.

[6] To note that MDA restrictions apply in case of breaches to the O-SII requirement.

3.2.2 Authorities' Reply

The Authorities are hereby clarifying that the data to be utilised for the purpose of the O-SII identification exercise is retrieved directly from the data reported in FINREP and prudential reporting as mandated by Banking Rule 06 and thus, no further input from banks will be requested in this regard.

3.3 Transitory Provisions

3.3.1 Feedback Received

Feedback was also received regarding the transitory period being proposed in the consultation as this differed from the phasing-in period adopted for the 2016 O-SII methodology.

Authorities' Reply

After duly noting the opinion of the ECB, the Authorities have decided to extend the transitory period until 1 January 2023 for the build-up of the O-SII buffer for newly identified O-SIIs.

4. Way Forward

After taking into account the feedback received from stakeholders, the Authorities will proceed by publishing the final O-SII policy document, accompanied by a Statement of Decision on the revised methodology on the identification and calibration of O-SII capital buffers. The decision will contain the list of credit institutions falling within the scope of this measure together with their applicable capital buffer rates.