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LSI SREP BENCHMARKING AND
SUPERVISORY EFFECTIVENESS



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TABLE OF ABBREVIATIONS

ALM	Asset and Liability Management
AML-CFT	Anti-money Laundering and the Countering the Financing of Terrorism
AMLD	Anti-Money Laundering Directive
BM&P	Business Model and Profitability
C&E	Climate and Environmental
CRD	Capital Requirements Directive
CRR	Capital Requirement Regulation
DORA	Digital Operational Resilience Act
EBA	European Banking Authority
ECB	European Central Bank
EGDQ	Extra Data Quality Checks
ESA	European Supervisory Authorities
ESG	Environmental, Social and Governance
EVE	Economic Value of Equity
FAP	Fitness-and-Properness
FCC	Financial Crime Compliance
FIAU	The Financial Intelligence Analysis Unit
GRC	Governance, Risk and Compliance
ICAAP	Internal Capital Adequacy Assessment Process
ICT	Information and Communication Technology
IGRM	Internal Governance and Risk Management
ILAAP	Internal Liquidity Adequacy Assessment Process
IRRBB	Interest Rate Risk in the Banking Book
ITS	Implementing Technical Standards
LSI	Less Significant Institution
MEL	Minimum Engagement Level
MFSA	Malta Financial Services Authority

MiCAR	Markets in Crypto-Assets Regulation
ML-FT	Money Laundering- Financing of Terrorism
MYA	Multi-Year Approach
NCA	National Competent Authority
NFC	Non-Financial Corporation
NII	Net Interest Income
NPE	Non-Performing Exposure
NPL	Non-Performing Loan
ODP	Online Deposit Platform
OSI	On-Site Inspection
OSS	Overall SREP Score
P2G	Pillar 2 Guidance
P2R	Pillar 2 Requirement
ROA	Return on Assets
ROE	Return on Equity
RTS	Regulatory Technical Standards
SFDR	Sustainable Finance Disclosure Regulation
SI	Significant Institution
SIRC	Supervisory ICT Risk and Cybersecurity
SNCI	Small and Non-Complex Institution
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
TCB	Third-Country Branch
TPP	Third-Party Provider
TR	Thematic Review

1.0 EXECUTIVE SUMMARY

This publication aims to present an analysis of the Supervisory Review and Evaluation Process (“SREP”) findings conducted by the Malta Financial Services Authority (“MFSA”) over the past five years, alongside insights from the European Central Bank (“ECB”). This communication aims to furnish credit institutions with a thorough understanding of industry benchmarks, and insights into the evolution of risk management practices across the Maltese banking sector.

The MFSA undertakes a full SREP assessment on credit institutions. The level of risk and management of controls of credit institutions has been assessed under the various economic and financial market disruptions, namely the conflict between Russia and Ukraine and high inflation resulting in rapid interest rate hikes.

Overarching results have shown that the Maltese banking sector has consistently exhibited resilience in the face of global economic conditions, efforts to combat inflation, ongoing geopolitical tensions as well as the evolving financial market dynamics. Despite these challenges, local credit institutions have continued to maintain robust capital and liquidity positions, with pockets of vulnerabilities alongside decreasing non-performing loan levels. The pace of digitalisation is influencing the manner in which credit institutions operate, and it gives rise to the need for a sustained investment. On the compliance side, credit institutions need to adapt to a plethora of evolving regulatory standards such as the Digital Operational Resilience Act (“DORA”), EU Capital Requirements Regulation (“CRR”) III/ Capital Requirements Directive (“CRD”) VI, environmental, social and governance (“ESG”) regulations and, Anti-Money Laundering Directive (“AMLD”) VI. Against this backdrop, higher investment outlays and operating expenditure may be needed in areas such as compliance, risk management as well as data controls and integrity.

The rapidly changing global financial environment necessitates continuous adaptation by credit institutions. The ongoing digital transformation, driven by technological advancements, is reshaping the delivery of banking services, making innovation a critical priority. This technological evolution requires significant investment in IT infrastructure and skilled personnel, posing challenges, particularly for smaller institutions with limited resources.

In this increasingly complex regulatory landscape, there is undoubtedly the need for heightened emphasis on measures in relation to anti-money laundering and combatting the financing of terrorism (“AML-CFT”). While regulations in this sphere are essential for maintaining the sector’s integrity and stability, they also present significant challenges in terms of implementation. Effective governance is pivotal for navigating these regulations, ensuring not only regulatory compliance but also strategic foresight and comprehensive risk management.

In meeting these evolving demands, the MFSA emphasises the need for banks to continue reinforcing their governance structures. This entails a strong commitment to transparency, accountability, and ethical conduct, which are essential for maintaining stakeholder trust and ensuring the sector’s long-term sustainability. Furthermore, as global focus intensifies on ESG matters, credit institutions must integrate such considerations into their business models and operating processes. Aligning operations

with global sustainability goals is not only a compliance requirement but also an opportunity for leadership in sustainable finance, potentially attracting investment and fostering long-term growth.

The SREP assessment allows competent authorities to assess the soundness of banks, considering the risks, including those emerging, that are relevant to their business model, and ensuring that such risks are well managed, enabling the institutions to be sufficiently resilient against possible shocks.

Over the past five years of SREP assessments, the MFSA has assessed that most of the Less Significant Institutions ("LSIs") posed a medium risk as per the supervisory objectives set out in the MFSA's strategic priorities for the respective years. In this respect, the majority of LSIs have achieved an average overall SREP Score ("OSS") of 3. The total capital requirement has remained within the range of 15.2% to 16.5%. The average Pillar 2 Requirement ("P2R") has improved slightly to 4.0% and within the range of 3.5% and 4.5%. In line with the MFSA's P2R Calibration Framework, a governance add-on within the range of 1.0% to 3.0% is applied in cases where credit institutions exhibit governance-related risks that are not captured by the standard P2R. Other risk-specific add-ons may also be considered.

In the case of the Pillar 2 Guidance ("P2G"), following the removal of the 1.0% floor maintained during the coronavirus period, the MFSA places LSIs in one of its three buckets, namely 1.0%, 1.5% or 2.0%, according to the quality of the LSIs' stress testing framework. Most of the LSIs fit within the 1.5% bucket. The MFSA is working with the credit institutions to improve the stress testing frameworks presented yearly in their Internal Capital Adequacy Assessment Process ("ICAAP"), *inter alia* through SREP, as well as through its Compliance Outcomes Based Approach exercise among a sample of banks as further described in section 4.0 of this publication.

Throughout the SREP cycles carried out in the last 5 years, the MFSA issued 380 qualitative requirements and recommendations to the LSIs, of which approximately 170 address gaps related to internal governance and controls. This trend highlights the ongoing challenges in the effectiveness of boards and committees, internal control functions and overall governance structures. The supervisory measures related to operational risk and credit risk have also been on a rising trend, indicating emerging vulnerabilities that require vigilant monitoring and proactive mitigation strategies. More recent measures related to liquidity risk and the interest rate risk in the banking book ("IRRBB") have been mainly triggered by the changing macro-financial landscape. The number of supervisory measures implemented in relation to the business model element have remained stable throughout the years. Despite the generally persistent positive performance among the LSIs, the MFSA continues to be cautious around the longer-term sustainability of some business models.

This document will provide an unprecedented comprehensive summary of the outcomes of SREPs conducted between 2020 and 2025 and is intended to provide banks with insight into the process. Chapter Two delves into the legal aspects of SREP. Chapter Three explores the SREP assessment as carried out by the MFSA and delves into key insights of the qualitative and quantitative measures imposed on the LSIs. Chapter Four describes how SREP contributes to addressing the MFSA's Supervisory Strategy and Priorities. Chapter Five offers a benchmarking analysis of these findings against EU LSIs. Chapter Six details the latest regulatory developments and strategic priorities. Finally, Chapter Seven presents the concluding remarks.

2.0 LEGAL AND OPERATIONAL FRAMEWORK

2.1 THE SINGLE SUPERVISORY MECHANISM

The role of the Single Supervisory Mechanism (“SSM”), encompassing the European Central Bank (“ECB”) and the National Competent Authorities (“NCAs”) of participating Member States, is to ensure consistent and effective implementation of EU policy on the prudential supervision of credit institutions in the euro area, maintaining supervision of the highest quality.

The ECB oversees the functioning of the system based on the procedures and responsibilities outlined in the SSM Regulation Framework, which delineate the roles of the ECB and NCAs for both significant institutions (“SIs”) and less significant institutions (“LSIs”). The ECB and NCAs perform their tasks in close cooperation, considering their economic and organisational specificities. The ECB is responsible for the direct supervision of SIs through Joint Supervisory Teams comprising experts from both the ECB and NCAs, while NCAs supervise LSIs using their own resources and decision-making procedures.¹

2.2 OVERSIGHT OF LESS SIGNIFICANT INSTITUTIONS

In its oversight role, the ECB is tasked with ensuring the effective and consistent operation of the SSM. The ECB must guarantee a level playing field for all credit institutions within the euro area while considering the unique characteristics of the national banking systems and their respective supervisory approaches.²

Proportionality is crucial in this context, leading the ECB, in collaboration with NCAs, to develop a classification regime for LSIs. This regime ensures that the supervisory and oversight approach is proportionate to the risks posed by the individual credit institutions.

LSIs are classified as High-Impact or High-Risk based on their effect on the financial system and their risk profile. High-Impact status is reassessed annually, and the results are published on the ECB’s official website. Additionally, LSIs are further categorised with the introduction of the small and non-complex institutions (“SNICs”) definition in the CRR. The MFSA conducts a biennial assessment against this definition, in line with article 4(145) of Regulation (EU) No 575/2013, as amended by Regulation 2019/876.

The MFSA follows this classification regime to ensure that proportionality is applied. In particular, the MFSA applies these classifications as the basis for its multi-year approach (“MYA”) to SREP and to determine its level of supervisory engagements in terms of frequency, scope, and depth of the

¹ European Central Bank, ‘Supervisory Manual’ (2024). Available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisory_guides202401_manual.en.pdf, accessed 22.08.2025

² European Central Bank, ‘Supervision and Oversight of Less Significant Institutions’ (2025). Available at <https://www.bankingsupervision.europa.eu/framework/lsi/html/index.en.html>, accessed 22.08.2025

supervisory reviews. This allows for more focus on specific topics each year, while allowing credit institutions time to implement the qualitative supervisory measures set in prior SREP years.

On 16 January 2025, the EBA published its Peer Review Report on the application of proportionality in SREP. The Peer Review covered a sample of six NCAs, selected to be broadly representative of the range of prudential supervisors across the EU.³ The MFSA has assessed its own practices against those set out in the Peer Review. The Authority notes that it is largely implementing proportionality in its SREP assessment, with some adaptations made to tailor to the local context and the risk profile of the credit institutions subject to its supervisory remit.

2.3 THE MFSA POLICY FRAMEWORK

In accordance with Directive 2013/36/EU, as amended by Directive 2019/878/EU, and as transposed in the Banking Act (Cap. 370 of the Laws of Malta) (“the Act”) and related Regulations, the MFSA, as the competent authority, is required to review the arrangements, strategies, processes, and mechanisms implemented by licensed credit institutions. Under regulation 3(1) of the Banking Act (Supervisory Review) Regulations (“the Regulations”), the MFSA must evaluate the risks to which credit institutions are, or may be, exposed, including risks identified through stress-testing, taking into account the nature, scale, and complexity of the institution’s activities. Through the SREP, the MFSA determines the supervisory measures applicable to each institution, in accordance with article 17E of the Act and regulation 9 of the Regulations.

The Banking Supervision Function within the MFSA is responsible for conducting these evaluations, following the ECB’s SREP framework. The MFSA sets out the principles underlying the SREP assessment in Banking Rule BR/12 on the Supervisory Review Process of Credit Institutions. This ensures that licence holders and other stakeholders receive clear information on how the MFSA carries out its analysis.

In a report dated 13 December 2024, titled ‘LSI Supervision Report 2024’, the ECB informed its external stakeholders that the SREP methodology is undergoing a cycle of reviews stemming from regulatory changes, emerging risks, and to align with the methodology applied towards SIs.⁴ The MFSA is actively involved in the process leading to the completion of the SREP methodology, with the aim of contributing and influencing the methodology.

³ European Banking Authority, ‘EBA Published its Peer Review on the Application of Proportionality under the Supervisory Review and Evaluation Process’ (2025). Available at <https://www.eba.europa.eu/publications-and-media/press-releases/eba-publishes-its-peer-review-application-proportionality-under-supervisory-review-and-evaluation>, accessed 02.08.2025

⁴ European Central Bank, ‘LSI Supervision Report 2024, (2024). Available at <https://www.bankingsupervision.europa.eu/ecb/pub/html/LSIreport/ssm.LSIreport2024~b8dd7cda4f.en.html>, accessed 02.08.2025

3.0 SUPERVISORY REVIEW AND EVALUATION PROCESS

The MFSA, through SREP, carries out an in-depth assessment of the risks posed by credit institutions and reviews whether they are equipped to manage these risks in the most efficient way, taking into account strategic priorities and goals. In this respect, the primary objective of SREP is to evaluate whether credit institutions have sufficiently robust internal governance and risk management frameworks to identify, measure, and cover their risks under business-as-usual and stressed scenarios. This comprehensive assessment addresses both the individual credit institution's resilience and the potential systemic risk posed to the broader financial system.

The SREP allows competent authorities to obtain a holistic and forward-looking evaluation of a credit institution's viability. It encompasses a "constrained judgement" approach, ensuring that assessments are both consistent and transparent, while allowing for the consideration of each institution's unique complexities and specific characteristics. The "constrained judgement" principle allows NCAs to consider the specificities of the credit institution's risks and, thereby allowing for a deviation in the scores, while remaining guided by the SREP methodology to ensure consistency across the supervisory judgements within the SSM.

The methodology focuses on assessing the credit institutions' risk profile from four different angles, namely business model and profitability ("BM&P"), internal governance and risk management ("IGRM"), risks to capital, and risks to liquidity and funding. Credit institutions may also be exposed to ML-FT risks. The MFSA, through SREP, may identify potential warning signals of ML-FT risk and can share such information with the AML-CFT supervisory authority for further action. Furthermore, the MFSA considers the potential impact of ML-FT risk exposure on various prudential elements of the credit institutions, particularly in the risk areas covered under SREP.

3.1 MFSA GOVERNANCE PROCESS TO SREP

The MFSA employs a structured and consistent governance process before issuing its SREP Decisions, aimed at ensuring rigorous oversight and alignment with European regulatory standards. The MFSA's governance process represents a transparent framework that ensures credit institutions in Malta maintain sound risk management practices and adequate capitalisation [Figure 1].

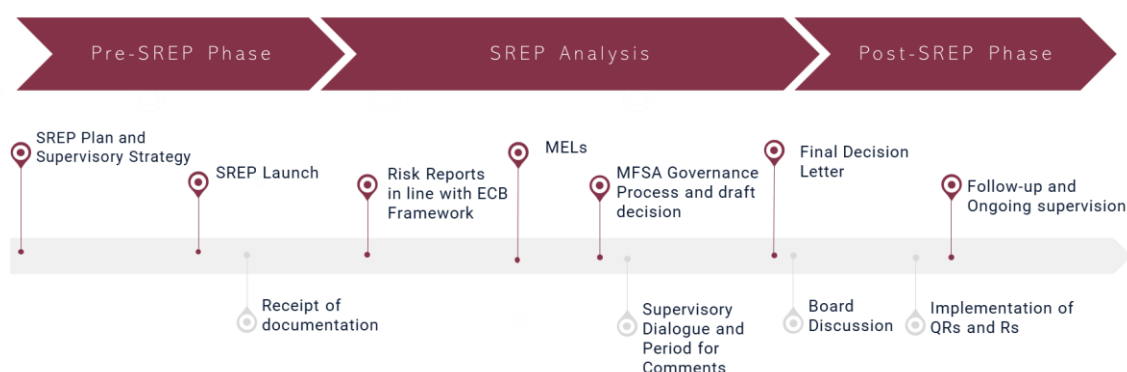
The SREP process begins with the formulation of a plan by the MFSA, which defines the scope and objectives for the supervisory cycle, considering the credit institution's complexity, size, and risk profile. This stage is followed by the launch of SREP during which the MFSA collects essential documentation for its desk-based review.

Upon receipt of these documents, the MFSA undertakes an in-depth risk assessment, evaluating the risk elements to SREP. The assessment is complemented with the information gathered through interactions with key function holders, which the MFSA undertakes in line with its annual Minimum Engagement Level ("MEL") plan. The findings are subsequently discussed at multiple MFSA Senior Management fora, following which, the MFSA engages in a Supervisory Dialogue and Period for

Comments with the Executive Management of the respective credit institution. During this phase, the results of the risk assessment are communicated, and the institution is granted the opportunity to provide additional information or clarifications. This dialogue promotes transparency and enables constructive engagement on the proposed supervisory measures.

Once the Period for Comments concludes, the findings and supervisory measures are presented to the Board of Directors. The Board is expected to endorse the MFSA's outcome to enhance the institution's risk management and governance practices. The MFSA continues to follow up on SREP Qualitative Requirements and Recommendations through its ongoing supervisory work.

Figure 1: MFSA Governance Process to SREP



3.2 OVERALL SCORE EVALUATION AND KEY TRENDS

The MFSA is hereby providing an in-depth analysis of its SREP assessments with the aim to provide credit institutions with a thorough understanding of industry benchmarks and insights into the evolution of risk management practices across the Maltese banking sector. This publication covers 24 SREP Decisions and 380 supervisory measures issued between 2020 and 2025.

The observations and assessments in this report are based on SREP Decisions as follows:

Figure 2: Number of SREP Decisions and Supervisory Measures



This publication excludes SREPs undertaken for credit institutions that have since surrendered their banking licence. Supervisory measures include qualitative requirements and recommendations. The MFSA defines qualitative requirements as non-numerical expectations imposed on credit institutions under SREP, aimed at addressing the identified weaknesses. Recommendations are suggestions put forward for credit institutions to be well-aligned with industry best practices and guidelines, mainly in

order to enhance resilience. The MFSA expects credit institutions to address both requirements and recommendations. In the case of the latter, if a bank does not intend to abide by the recommendation, then the MFSA expects it to submit a comprehensive rationale covering such non-compliance.

The MFSA uses the SSM’s grading scheme in terms of the EBA Guidelines on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process (EBA/GL/2022/03), with a score of 4 showing high risk and a score of 1 showing the lowest risk. The scores of 2 and 3 signal medium-low and medium-high risk, respectively. From the 2023 SREP cycle and since, the MFSA opted to make use of score qualifiers (“+” or “-”) to provide further granularity in its assessment, and accuracy in reaching its final conclusions. The qualifiers may only be used with the score of 2 and 3, as portrayed hereunder.⁵

Figure 3: SREP Scoring Grid

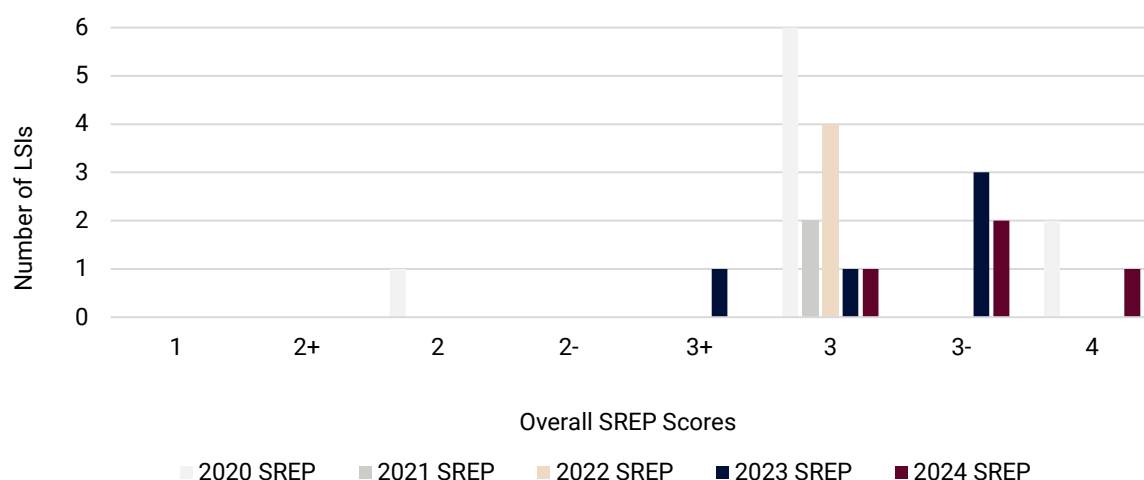


Source: EBA Guidelines on Common Procedures and Methodologies for the SREP (EBA/GL/2022/03)

3.2.1 OVERALL SREP SCORES

Figure 4 shows the overall SREP scores during the five years of SREP, with the large majority of overall SREP scores clustered within the score of 3, and to a lower extent, higher than 3.

Figure 4: Overall SREP Scores



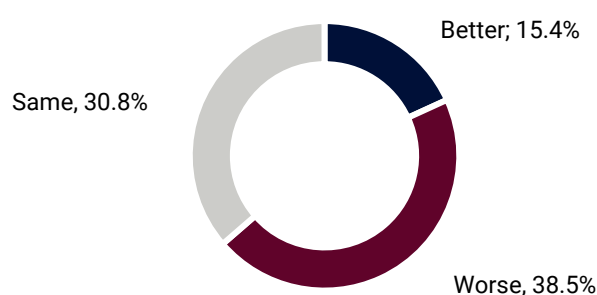
NOTE: 2020 SREP values are based on 9 decisions, 2021 SREP on 2 decisions, 2022 SREP on 4 decisions, 2023 SREP on 5 decisions and 2024 SREP on 4 decisions. This chart excludes SREPs undertaken for those credit institutions that have since surrendered their banking licence.

⁵ European Banking Authority, 'Guidelines on Common Procedures and Methodologies for the SREP and Supervisory Stress Testing under Directive 2013/36/EU' (2022). Available at <https://www.eba.europa.eu/>, accessed 05.05.2025

Throughout the five years of SREP, and for those LSIs that have been subject to at least two SREP cycles, 30.8% of the LSIs have maintained the same overall SREP score, whilst 38.5% saw their scores deteriorating and 15.4% improved their overall score [Figure 5].

For LSIs not undergoing a SREP assessment within a particular year, the MFSA performs its ongoing supervisory work, that entails frequent interactions with the institutions and consistent oversight of their activities. In the case that significant developments are observed, either positive or negative, a revised letter, a change in quantitative requirements, or both, may be issued to ensure that SREP requirements remain fit for purpose.

Figure 5: Changes to overall SREP Scores



NOTE: This chart is based on those LSIs that have undergone at least two SREP cycles and, therefore the coverage differs slightly from that of the data provided in Figure 4.

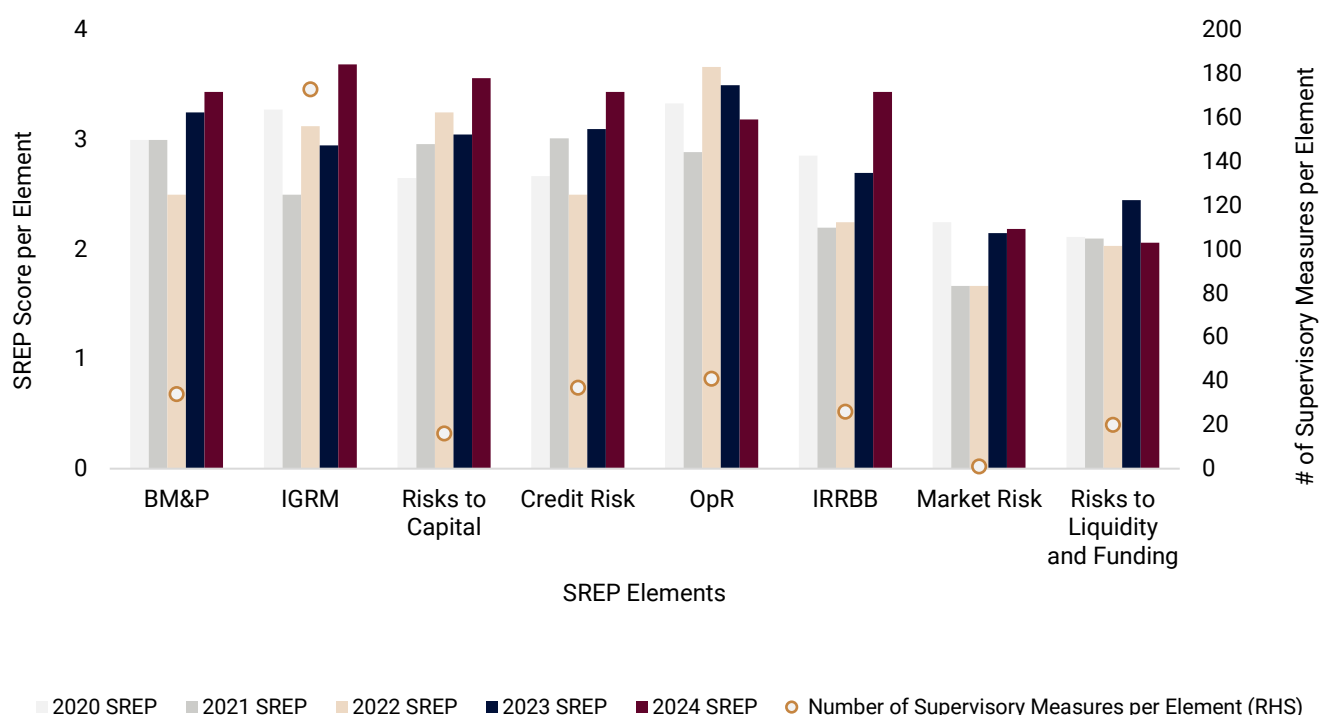
The MFSA's Banking Supervision Function integrates the outcome of other supervisory interactions, including those cross-functional, into its SREP assessments, to allow for a more holistic approach and thereby consider all relevant risks and their interdependencies on the institutions' profile. These interactions include, *inter alia*, on-site inspections, thematic reviews and self-assessment questionnaires, with such findings contributing to the SREP outcome and possible supervisory actions.

In assessing the SREP elements [Figure 6], operational risk recorded the highest average score across the SREP years. This was mainly driven by limited operational risk management policies and weak IT-risk management systems. Although the rapidly evolving technological landscape may pose future challenges, recent improvements in profitability and capital adequacy are likely to support further investment in these areas.

Internal Governance and Risk Management ("IGRM") is also deemed as posing an elevated risk, mainly stemming from weak and outdated policies and behavioural standards, including, at times, a culture that hinders the effective management of the credit institution.

On the credit risk front, there was a noticeable improvement in the LSIs' stock of non-performing loans ("NPLs") towards 2023. The high NPL ratio was predominately driven by the SME segments within non-financial corporations ("NFCs") rather than by households' portfolios. Nonetheless, the persisting high score is the result of gaps identified within the management of credit risk, including instances of inadequate or low coverage ratios and credit concentration risk.

Figure 6: SREP Score per Element against total QRs and Rs



NOTE 1: 2020 SREP values are based on 9 decisions, 2021 SREP on 2 decisions, 2022 SREP on 4 decisions, 2023 SREP on 5 decisions and 2024 SREP on 4 decisions. This chart excludes SREPs undertaken for those credit institutions that have since surrendered their banking licence.

NOTE 2: IC(L)AAP-related supervisory measures are included within the respective risk element where the gap has been observed. Stress testing-related supervisory measures are considered separately and are further described in section 3.2.3 of this publication.

Given that internal governance and operational risks remain elevated, and that credit risk continues to be the primary threat for most credit institutions, the MFSA has focused its supervisory priorities on Governance, Risk and Compliance (“GRC”), Digital Finance, and the Resilience of the Business Model. Section 4.0 of this publication provides detailed information on how the overall SREP outcomes inform the MFSA’s approach to these supervisory priorities.

3.2.2 KEY INSIGHTS AND OBSERVATIONS FROM SREP

The SREP analysis provides valuable insights for regulators, credit institutions and the wider interested public to guide future supervisory actions and strategic initiatives aimed at ensuring the longer-term sustainability of the banking sector.

The charts illustrated in this section provide a visual representation of the supervisory measures imposed on LSIs throughout the past five-year of SREP assessments, distinguishing the data into *First SREP* and *Second SREP* to help track the evolution of supervisory actions. The data includes the same sample of LSIs that have been subject to two cycles of SREP between the year 2020 and 2025. The total 380 supervisory measures continue to highlight the necessity for LSIs to prioritise their key vulnerabilities within their institution and ensure alignment with supervisory priorities and guidelines.

ELEMENT 1: BUSINESS MODEL & PROFITABILITY (“BM&P”)

The BM&P assessment aims to develop a comprehensive understanding of the credit institutions' business propositions, operating models and financial projections. The BM&P review provides insights into the ability of credit institutions to generate acceptable returns over the following 12-month period (viability) and a longer-term period of 3–5 years (sustainability), based on strategic priorities and management execution capabilities. Identifying vulnerabilities within this element helps pinpoint specific risks to solvency and liquidity that are material to the respective credit institution, thereby supporting the evaluation of other SREP elements.

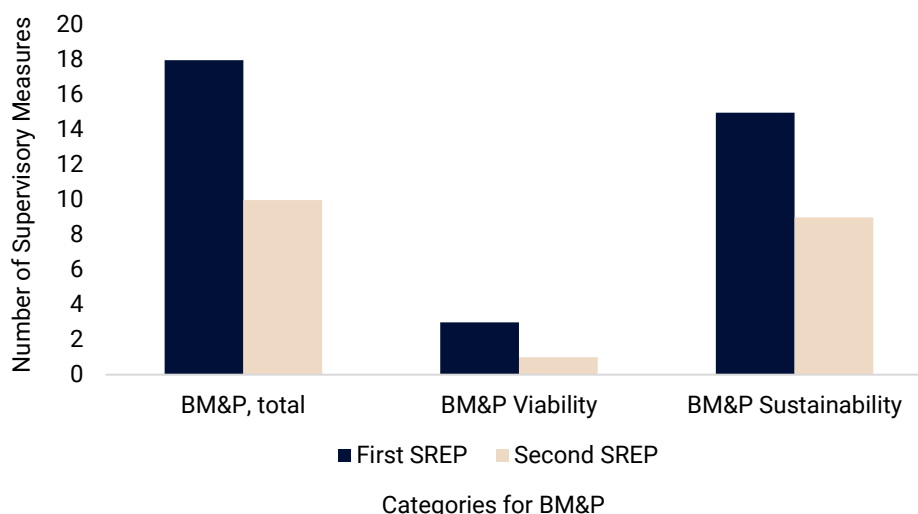
A total of 28 supervisory measures tackled deficiencies within the BM&P assessment [Figure 7]. The MFSA observes that the Maltese LSI banking sector has largely navigated well through the challenges in recent years. Overall, the short-term viability is not considered as vulnerable, as profitability levels were generally maintained at robust levels. Indeed, only a small number of measures were related to viability concerns.

Nonetheless, the MFSA emphasised that banks should consider potential challenges to their longer-term sustainability, emanating from, *inter alia*, heterogenous developments, internal dependencies and competitive pressures impacting their business models. Therefore, the sustainability-related supervisory measures do not necessarily imply tangible sustainability concerns but rather seek to ensure that banks are factoring future potential effects on their profitability, business model viability, and sustainability in their risk management discussions. The MFSA has observed good analysis performed by credit institutions in assessing whether their strategy has the capacity and resilience to address the identified threats to their longer-term sustainability.

The second observation that was repeatedly noted related to shortcomings in the financial forecasts put forward by the LSIs which were at times deemed to be overoptimistic, based on unrealistic assumptions about the future business environment and/or not adequately capturing the emerging business risks. The MFSA requested that LSIs provide assurance that such forecasts are adequately incorporating the challenges within the macroeconomic landscape and reflecting the institution's competitive position for its products and services in its chosen markets. Among the best practices identified to address these findings are presentations of budget versus actuals, supplemented by clarifications on possible changes in business lines or organisational structures aimed at effective cost-cutting.

Whereas the MFSA encourages credit institutions to identify and incorporate the competitive sphere in assessing their viability and sustainability, it acknowledges that there are cases where no relevant peers can be recognised. This is mainly because of their specific business model that targets different sources of profits or customer segments. In such cases, the MFSA expects that a stand-alone analysis is performed and, that it is not only based on the standard profitability ratios but also considers the funding, liquidity and capital profile of the credit institution itself vis-à-vis its risk appetite. The credit institution should clearly demonstrate to the MFSA the link between its risk-taking approach and the capability to generate returns.

Figure 7: Business Model and Profitability Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the business model and profitability SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 2: INTERNAL GOVERNANCE & RISK MANAGEMENT (“IGRM”)

The IGRM assessment adopts an institution-wide perspective, evaluating a credit institution’s overall management of risks through appropriate internal control functions and oversight. It does not cover the analysis of controls related to capital or liquidity and funding risks, which are assessed separately for each risk category. Consequently, in the IGRM assessment, the MFSA distinguishes between institution-wide risk control, addressed under Element 2, and risk-specific controls, covered under Elements 3 and 4 of the SREP.

The MFSA sets high standards for IGRM, requiring credit institutions to implement robust frameworks that ensure effective oversight and prudent risk-taking. LSIs have made notable strides within their internal governance and controls infrastructure, with some institutions improving their SREP scores. The MFSA has acknowledged the LSIs’ efforts in having balanced governance arrangements at Board level, comprising a broad range of expertise relative to the risks posed by the institutions’ business model and activities. The MFSA has further observed a number of LSIs promoting Board diversity, with the onboarding of female members and representatives having a professional background in the fields of ESG and Information and Communication Technology, among others. Further work has been seen in building succession options to ensure continuity and sustainability of both Board and Key Function Holders’ oversight.

Nonetheless, the majority of supervisory measures along the years of SREP remain focused on IGRM, with a total of 155 measures [Figure 8]. There is only a slight variation in the number of measures imposed in the first round of SREP compared to the second, at times indicating persistent or recurring issues in the overall governance arrangements of LSIs. In this respect, the MFSA would like to highlight

that the SREP assessment goes beyond the tangible elements of governance. In effect, the MFSA continues to target gaps within the risk management framework, such as instances of outdated risk appetite frameworks that are not reflective of the institution's actual risk profile, and unclear escalation processes should risk limits be breached.

In addressing the MFSA's supervisory measures, some LSIs have aligned their risk appetite framework to their respective business and risk strategies. Good practices also included LSIs demonstrating that they have properly implemented risk appetite considerations in the institution's risk limit system in line with the risk bearing capacity, and this was appropriately reflected in the internal reporting systems. Other common findings relate to risk appetite statements not being granular enough to capture all material risks and thresholds that are not in line with regulatory requirements.

The MFSA has on occasions also observed a weak risk culture, on the back of lack of a 'tone at the top' and opaque communication between the Board and senior management. Supervisory measures have been set around the MFSA's expectations for banks to have a culture of effective challenge, also demonstrated through appropriate records in Board and Committee meeting minutes. At times, these findings led to reservations around the proper oversight role and time commitment of the members of the Boards.

There have also been persistent findings regarding the effective functioning of the Three Lines Model. A handful of supervisory measures revolved around the Compliance Function and its role in ensuring that the credit institution complies with *all* applicable laws, regulations and internal policies, whilst monitoring the implementation of such requirements to avoid, mitigate or remediate cases of non-compliance. In many of the cases, the MFSA commented on the outdated policies that were not in line with the respective laws or regulations and/or were not reflective of the business propositions of the institution. This raised doubts on the effective operation of the Function in successfully identifying and preventing compliance issues.

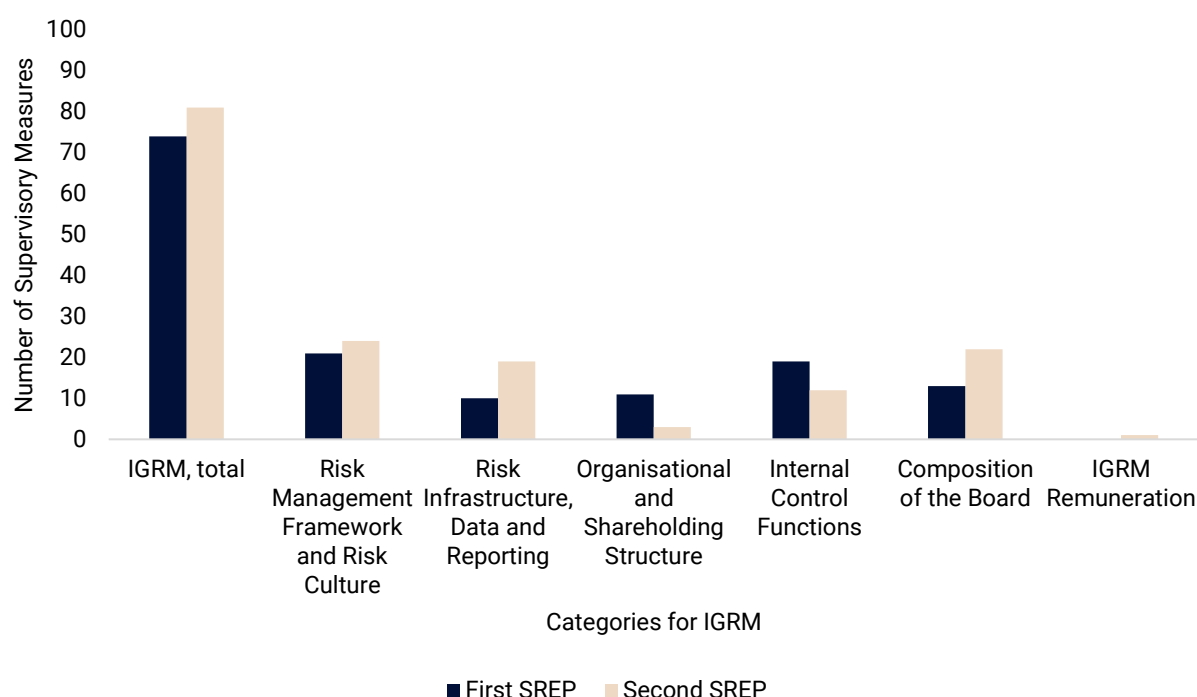
Other findings concerned the Internal Audit Function, particularly limited audit coverage and insufficient oversight of the institutions' material risks. In response, some LSIs have expanded their audit universe to address risks arising from their business activities, processes, and functions. Institutions are responsible for informing the MFSA if they are unable to meet the planned audit cycles. Other supervisory measures related to overdue pending audit matters. Some LSIs have enhanced their follow-up procedures to ensure that all audit recommendations are resolved in a timely and effective manner and provided concrete and realistic corrective actions for addressing findings.

The IGRM element also incorporates the assessment of the Recovery Plan, in accordance with regulation 6(2) of the Recovery and Resolution Regulation. In most cases, the MFSA has remarked on the importance that the management actions, as a response to the stress testing framework, are part of, or consistent with, the Recovery Plan. Other requirements and recommendations revolved around the credibility, feasibility and resolvability of the recovery options in restoring the viability and financial soundness of the credit institution in times of stress. Supervisory measures also tackled the requirement for banks to ensure full compliance with Chapter I section II of the Commission Delegated Regulation (EU) 2016/1075 under Directive 2014/59/EU.

The MFSA observed improvements in the overall quality of regulatory data submitted by LSIs, particularly in areas such as technical compliance and timeliness of submissions. However, material shortcomings remain - especially in relation to data completeness and accuracy - highlighting the continued need for stronger pre-submission controls and quality assurance processes. In line with supervisory expectations and the requirements set out in the Commission Implementing Regulation (EU) 2024/3117, SREP measures revolve around the institutions' need to enhance the reliability of their submissions by implementing sound internal validation practices aimed at minimising the need for corrections and resubmissions. This includes the routine application of the ECB's Expert Group on Data Quality ("EGDQ") checks, EBA validation rules, accurate use of template activation criteria and adherence to naming conventions and technical specifications.

The quality and timeliness of regulatory reporting remain important indicators of an institution's control environment, data governance maturity and overall regulatory alignment. Supervisory measures in this respect reflected assurance that all reporting processes - irrespective of their degree of automation - are governed by clear internal procedures and subject to adequate quality controls. Such practices not only reduce the likelihood of recurring reporting errors but also strengthen the reliability and comparability of supervisory data across the sector.

Figure 8: Internal Governance and Risk Management Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the internal governance and risk management SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 3: RISKS TO CAPITAL

The assessment of Element 3 involves the assessment of credit risk, operational risk, market risk and IRRBB. In addition, Element 3 captures the assessment of a credit institution's capital needs from a forward-looking perspective.

The ICAAP document is expected to incorporate the process the institution uses to determine its capital adequacy and the most accurate quantification of its internal capital needs over the medium-term to best cover the risks arising from its activities. The basis for a sound and resilient capital position is therefore a robust risk management framework that is capable of effectively identifying, measuring, and mitigating these risks.

It is important that credit institutions maintain a robust capital adequacy framework that not only complies with regulatory requirements but also reflects their unique risk profiles and business models. The framework must ensure there is sufficient capital to cover all material risks, including those not fully captured by the Pillar I requirements.

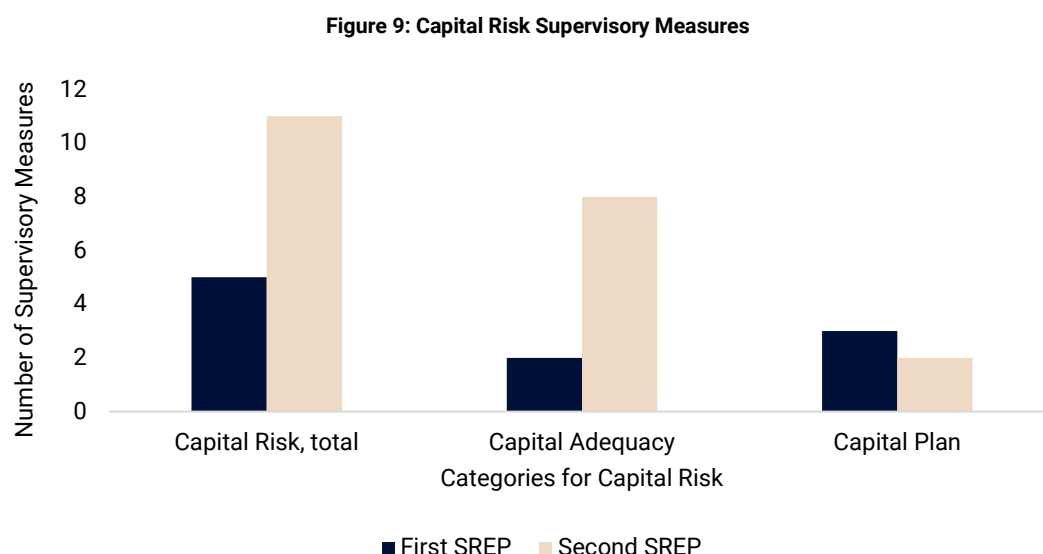
Capital adequacy scores have fluctuated throughout the past SREP cycles, and this is also reflected in the uneven number of supervisory measures imposed through the First and Second SREP [Figure 9]. On average, LSIs operate with a comfortable capital headroom that is made up of high-quality capital instruments and, accordingly, there are no immediate concerns around the overall capital situation of the LSI sector in Malta. Nonetheless, SREP revealed a number of findings around this area for particular LSIs, such as over-reliance on the Group for capital injections. Whereas the MFSA acknowledges that such injections portray the Group's commitment towards the business, the MFSA expects banks to be able to operate more independently and to build a capital plan that is consistent with their risk appetite and budgets.

Other supervisory measures around capital planning include requirements for banks to devise a scenario of the implications on the business model should capital injections not materialise and the identification of potential alternative sources, other than Group or shareholders' capital injections. The MFSA expects that the capital planning process is formalised and implemented through an effective and transparent governance structure that includes the input of diverse expertise across the institution; including the business, risk, finance and treasury departments and, ultimately, that Boards make strategic decisions that are consistent with these assumptions.

In tackling measures associated with capital plans, LSIs have provided detailed descriptions of the conclusions from capital planning such as planned issuances of the various capital instruments, other capital measures and planned changes to the balance sheet. LSIs have also incorporated projections considering potential risks and their impact on the banks' financials across different dimensions (example internal capital and regulatory own funds) over different time horizons.

The MFSA acknowledges that some credit institutions have single name large exposures. In this respect, the SREP showed that the consideration of large exposure limits when assessing capital adequacy was at times being omitted. LSIs were therefore requested to include, as part of their capital plan, how to direct capital so as not to be in breach of the large exposure limits laid down in the respective article of the CRR. Among the best practices in addressing the MFSA's measure is also

assurance that the institution has in place a process for prompt identification and escalation processes of early warnings and limit breaches.



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the capital risk SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 3.A: CREDIT AND COUNTERPARTY RISK

The average credit risk score remained within the range of medium-high risk. Gaps within credit risk controls, as well as high risk levels played a crucial role in the scoring of LSIs. This is also demonstrated by the almost even number of supervisory measures imposed under the different SREP cycles [Figure 10].

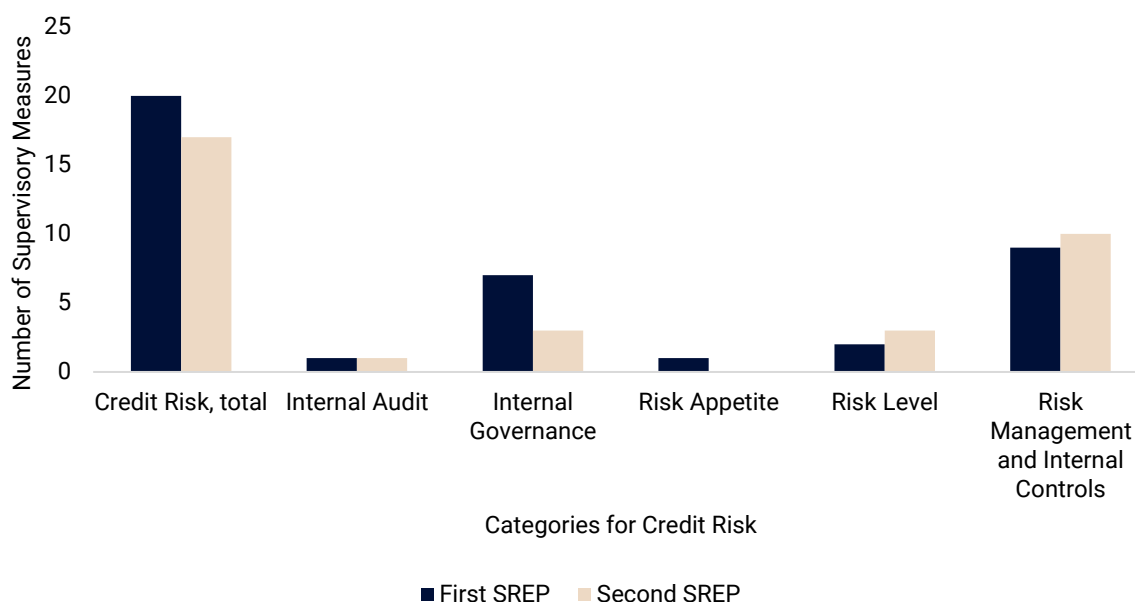
The MFSA's assessment focused on ensuring that credit institutions, particularly those exposed to credit risk, have appropriate mitigants in place. These include adequate provisioning and coverage levels, high-quality collateral, and robust implementation of credit risk management practices. In most cases, the supervisory measures under the 'Risk Management and Internal Controls' category reflected the MFSA's concerns in these areas. In some instances, LSIs have been requested to provide an external review to show whether the low coverage ratios presented a risk to current and future compliance with regulatory requirements. At times, the MFSA also remarked about provisioning and coverage levels that were below industry averages.

Gaps within credit risk controls were, at times, reflected in the lack of necessary input by the Internal Audit and Compliance Functions, and accordingly, LSIs were required to enhance their audit review and reconsider their existing policies and procedures. SREP revealed that, in some cases, credit risk policies lacked clear rules for the approval of credit facilities and well-defined decision-making processes. The LSIs were also requested to revise their policies to be fully in line with the CRR, the respective EBA Guidelines, and MFSA Banking Rules.

SREP also allows for an in-depth analysis of the LSIs' risk level through volume-based (for example, the share of portfolio exposures within a particular segment) and risk-based (for example, NPLs, Stage 2 ratio, loan growth and forbearance ratio) indicators. For banks with an above-threshold NPL level, the MFSA closely followed up the LSIs' NPL Strategies in terms of Banking Rule BR/09 on 'Measures Addressing Non-Performing Exposures and Forborne Exposures'. During these past years, LSIs made notable efforts in decreasing NPLs and bringing the overall levels beneath the 5% threshold prescribed by Banking Rule BR/09.

The 2022 SREP cycle reflected improvements observed following the on-site inspections ("OSIs") and thematic reviews ("TRs") performed on a sample of LSIs in 2021-22 on the timely identification and recognition of NPEs, which in turn, impact the level of provisioning, profitability and capital. LSIs worked on improving their governance processes, the recognition of forbearance measures, as well as on enhancing their early warning indicators and unlikely-to-pay triggers.

Figure 10: Credit Risk Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the credit risk SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 3.B: MARKET RISK

Most of the Maltese LSIs do not maintain trading book positions and, accordingly, overall exposure to market risk is negligible. Nonetheless, LSIs may still be exposed to movements in market prices emanating from foreign currency risk, unless adequate hedging strategies are in place. In this respect, a few supervisory measures revolved around the credit institution providing plans on how it shall manage market risk in accordance with its level of exposure and a remediation plan to address possible gaps within the risk management framework.

The MFSA recommended that credit institutions have separate policies and procedures in place that are in line with Banking Rule BR/24 on Internal Governance and that take into consideration the extent of exposures/ activities towards market risk.

ELEMENT 3.C: INTEREST RATE RISK IN THE BANKING BOOK (“IRRBB”)

The MFSA has increased its attention towards the monitoring of the management of risk emanating from IRRBB in LSIs, mainly triggered by the changing macro-financial landscape and increased uncertainty around its effects on the institutions’ banking books. The MFSA observes that some LSIs have also stepped up their efforts to assess and mitigate the risk on their non-trading activities, stemming from possible movements in interest rates. In particular, LSIs are employing the six prescribed scenarios to capture the effect of a potential parallel and non-parallel movement of the yield curve on the Economic Value of Equity (“EVE”) and two shock scenarios of parallel movement of the yield curve of ± 200 basis points for the Net Interest Income (“NII”) in line with EBA Guidelines EBA/GL/2022/14 on the Management of Interest Rate Risk. In doing so, institutions have started assessing the repricing of cash flows through dividing their balance sheet into 19-time buckets as defined in the standardised framework under the EBA on Final Draft Regulatory Technical Standards (EBA/RTS/2022/09 and EBA/RTS/2022/10).

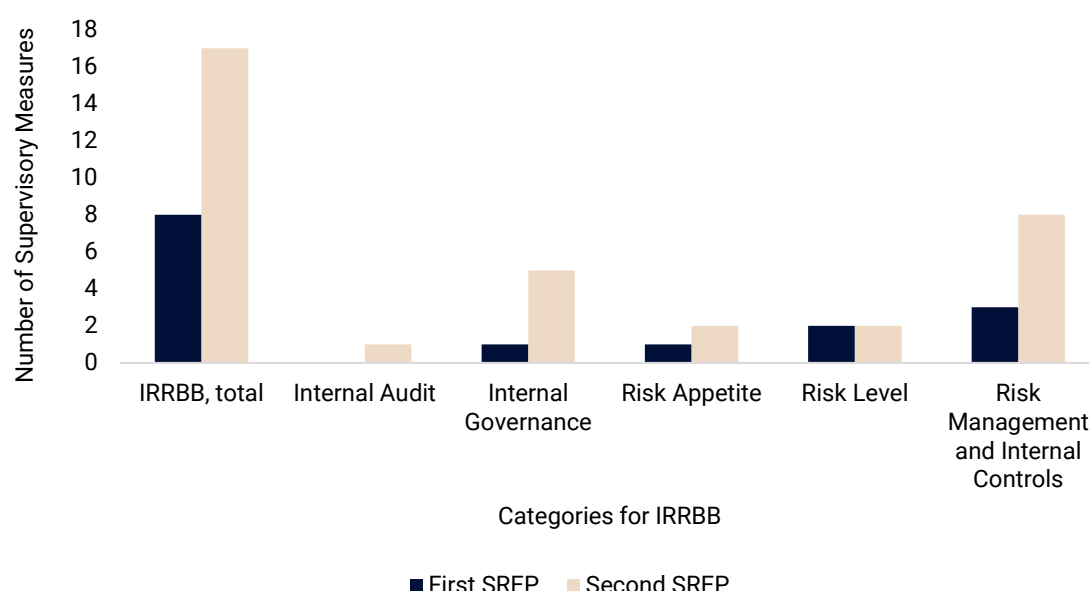
Nonetheless, a number of supervisory measures have still been imposed to cover gaps in IRRBB controls [Figure 11]. Recent SREPs revealed that some LSIs do not sufficiently embed IRRBB in their Board agendas and do not consider in their entirety the ‘Principles for the Management of Interest Rate Risk in the Banking Book’ as referred to in Annex 2F of Banking Rule BR/12 on Supervisory Review Process and the EBA Guidelines EBA/GL/2018/02 and EBA/GL/2022/14 on the Management of Interest Rate Risk. The MFSA encouraged members of the Board to increase discussion around this topic. Weak IRRBB management may erode profit margins and consequently expose the institution to broader vulnerabilities, including second-round impacts on credit risk, through borrower affordability shocks, and on liquidity risk, through destabilisation of funding profiles. This is of particular relevance to credit institutions having a large percentage of their assets in products that are highly sensitive to interest rate movements and heavy reliance of interest income as their main source of business. The MFSA has requested some LSIs to have in place proper internal controls mechanisms for IRRBB, including a management framework, a policy, and clear processes. These should be internally assessed and approved on an ongoing basis and independently reviewed to evaluate their effectiveness. The MFSA further requested that LSIs include a risk appetite and limits for IRRBB risk, expressed in terms of the acceptable impact of fluctuating interest rates on both earnings and economic value, as part of the bank’s strategy and objectives.

The MFSA observed that several LSIs exhibit limited awareness in managing the balance sheet structure from an integrated Asset and Liability Management (“ALM”) perspective, particularly regarding IRRBB exposures. Institutions are expected not only to identify, measure, and monitor IRRBB, but also to implement robust behavioural modelling practices. Weaknesses in modelling customer behaviour can materially distort both EVE and NII sensitivity results, reducing the effectiveness of the six shock scenarios. Behavioural models should be sufficiently sophisticated to capture the impact of book composition on both assets and liabilities, including factors such as early redemption and prepayment, which may arise from changes in market interest rates or competitive pressures.

The MFSA's assessment on the reporting requirements under the ITS at times also identified material inaccuracies in the institutions' submissions. Specifically, errors were detected in the reporting of sign conventions, where positive and negative values, which convey opposite impacts on the institution's exposures, were incorrectly assigned, thereby impairing the reliability of supervisory metrics and the proper interpretation of the banks' IRRBB profile. Furthermore, in some cases the reported 'duration' figures were found to be inconsistent with the institutions' actual business model and risk management approach, suggesting either the use of inappropriate measurement assumptions or misalignment between accounting classifications and risk modelling practices.

The MFSA stresses the need for policies that move beyond mere compliance and static measurement, towards active management strategies that hedge exposures, stabilise net interest margins, and protect the economic value of assets and liabilities over the interest rate cycle, as envisaged under article 98(5a) of the CRD.

Figure 11: IRRBB Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the IRRBB SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 3.D: OPERATIONAL RISK

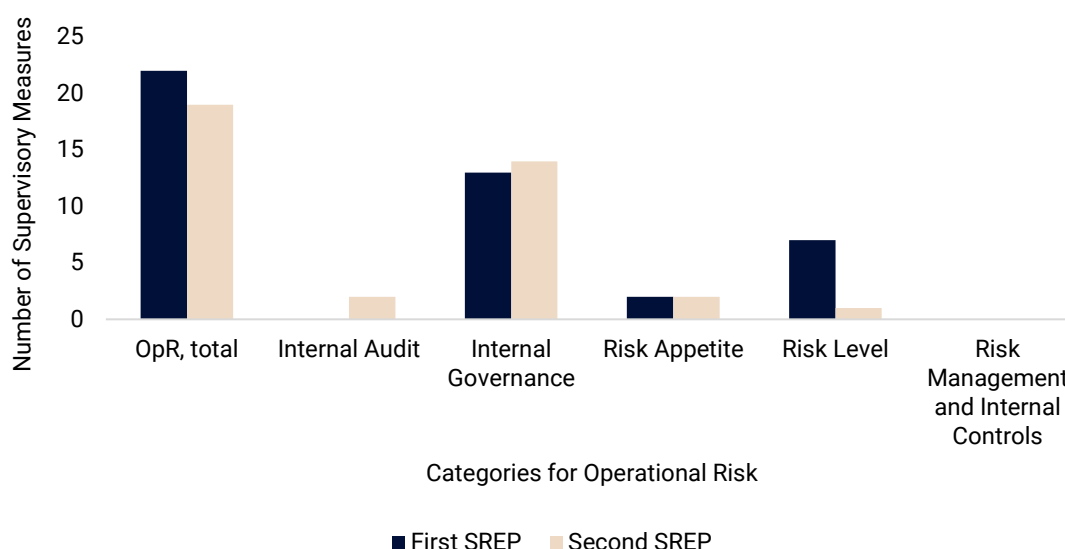
Operational risk continues to be the SREP element with the highest average scores. Whilst the MFSA notes that, overall, LSIs remained resilient to operational risk, with minimal operational losses incurred by the majority of institutions, deficiencies were still identified with respect to the governance aspect, mainly related to ICT and operational resilience. [Figure 12].

All LSIs undergoing SREP are requested to submit an ICT Risk Questionnaire that is designed in accordance with the EBA Guidelines and developed by the ECB along with other National Competent Authorities. The questionnaire is reviewed and assessed by the MFSA's Supervisory ICT Risk and Cybersecurity Function, and the overall outcome is reflected in the Operational Risk element of SREP.

The supervisory measures tackled the necessity for credit institutions to enhance the governance arrangements within IT and establish formal charters that clearly define the roles and responsibilities of Chief Information Officers and distinguish between the duties under the First and Second Line of Defence in accordance with the MFSA's Guidance document on Technology Arrangements ICT and Security Risk Management and Outsourcing Arrangements.⁶

The business continuity plan and disaster recovery plan are also assessed with the aim of understanding the level of resilience at the credit institution in the event of unplanned distributions. A number of supervisory measures focused on having the institution assessing its ability to determine tolerance levels for its critical functions including those outsourced. Amongst best practices, the MFSA has seen LSIs demonstrating that the plan is regularly tested and that the risk scenarios implemented capture the current market dynamics and evolving environment.

Figure 12: Operational Risk Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the operational risk SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

ELEMENT 4: LIQUIDITY AND FUNDING RISK

Credit institutions are required to maintain a comprehensive liquidity risk management framework that ensures they can meet their financial obligations as they fall due, even under stressed conditions. This framework must encompass both short-term and long-term liquidity positions and be robust enough to withstand potential market disruptions.

The average of the liquidity and funding combined risk scores can be observed to have remained relatively stable, reflecting generally robust liquidity positions in the midst of macroeconomic,

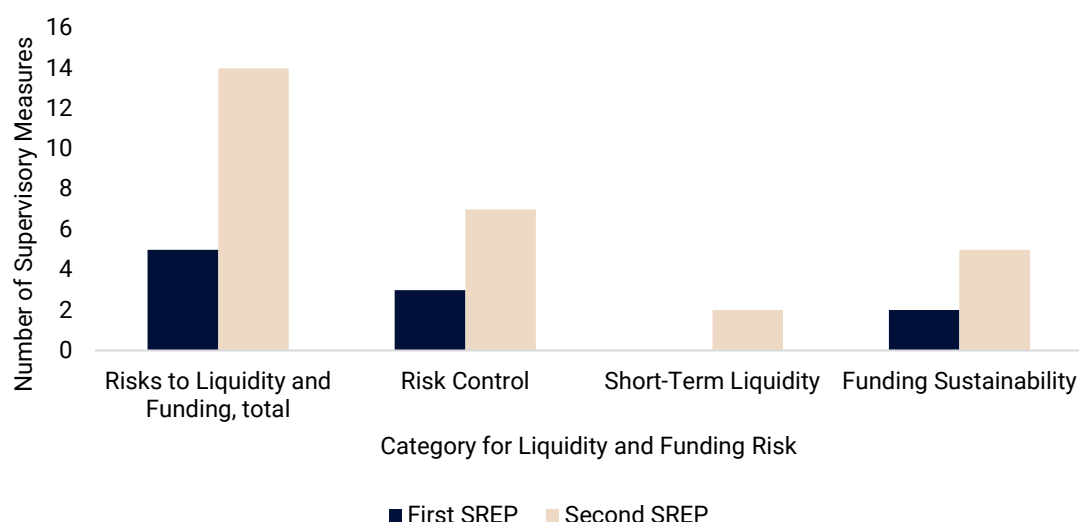
⁶ Malta Financial Services Authority, 'Guidance on Technology Arrangements ICT and Security Risk Management and Outsourcing Arrangements'. Available at <https://www.mfsa.mt/wp-content/uploads/2020/12/Guidance-on-Technology-Arrangements-ICT-and-Security-Risk-Management-and-Outsourcing-Arrangements.pdf>, accessed 07.05.2025

inflationary and geopolitical challenges [Figure 13]. Regulatory ratios also remained generally resilient. Nevertheless, the focus on funding risk shifted towards the challenges associated with some LSIs' significant reliance on Online Deposit Platforms ("ODPs"). Indeed in 2022, the MFSA assessed the management of ODP usage through a TR performed on a sample of LSIs. Supervisory measures in this area were reflected in the 2022 and 2023 SREP cycles, which, among other requirements, tasked LSIs with evaluating the impact of adverse interest rate movements on the availability and viability of funding. Institutions were also required to demonstrate the stability of their funding and outline strategies to manage associated costs in light of their profitability forecasts. Further details on the outcome of this review will be provided in an upcoming MFSA publication on the 'Supervision of Online Deposit Platforms'. The planned publication is proposed to cover the growing use of ODPs within the Maltese banking sector and the importance for credit institutions to understand the related risks and opportunities as well as the prudential treatment of ODPs in terms of liquidity and funding ratios.

Although the MFSA recognises the difficulties encountered by small institutions to tap into different sources of funding, the Authority acknowledges the efforts made by some LSIs to diversify across funding platforms and other types of deposits, and to boost the robustness of the control environment around funding.

The majority of supervisory measures were related to the risk control aspect, in particular, to liquidity and funding contingency plans at times not being adequately maintained and tested. The MFSA further observed breaches in escalation processes, with these sometimes not being fully aligned with the banks' own policies and procedures and lacking granular risk appetite statements, thus failing to capture the risk stemming from funding, depositor and maturity concentration risks.

Figure 13: Liquidity and Funding Risk Supervisory Measures



NOTE: This chart includes the number of supervisory measures imposed on LSIs with respect to the liquidity and funding risk SREP element. The data includes the same sample of LSIs that have been subject to two SREP cycles, irrespective of the year under assessment.

3.2.3 STRESS TESTING AND SCENARIO ANALYSIS

The MFSA supervises LSIs' stress testing frameworks, and this analysis subsequently feeds into the bank-specific P2G calibrations, indicating the level capital banks are expected to maintain in addition to the binding capital requirements. Further details on the P2G are provided hereunder. The MFSA undertakes a qualitative assessment and uses its in-house P2G Calibration Framework to calculate the final guidance.

The framework is centred around the following:

- Strategy and capital planning: whether the stress test scenarios are severe and granular enough to be used in capital and liquidity planning
- The governance process: whether there is a formalised process around the creation, selection and review of the scenarios implemented by the bank, and that this can be clearly evidenced through Board and Committee meeting minutes
- The use of benchmarking: whether assumptions used are backed by appropriate and reliable data
- The business model: whether the scenarios-generating processes are appropriate to the business model of the bank and that they capture all relevant weaknesses of the bank, both from a micro and macro perspective, and
- The macroeconomic considerations: whether the bank is taking into account narratives that are linking the micro and macro parameters in the stress scenarios with the key vulnerabilities resulting from the business and operating model of the bank.

Furthermore, the MFSA considers the impact of the stress test on the bank's capital position, focusing on the extent of capital depletion under both the baseline and adverse conditions.

The majority of the MFSA's supervisory measures related to the banks' stress testing frameworks were targeted to address the above-mentioned factors. Year-on-year the MFSA continues to observe improvements in stress testing, however there is still room for improvement. A handful of LSIs still fail to include reverse stress testing and rely heavily on the support provided by the group during times of stress. The MFSA expects management intervention and mitigating actions that are credible and feasible to address the stress tests' output.

3.2.4 Pillar 2 Requirement ("P2R") and Pillar 2 Guidance ("P2G")

In addition to the qualitative requirements and recommendations, the SREP Decision requires banks to hold additional capital that is in excess of the minimum required in terms of article 92 of the CRR, namely the P2R, and to comply with a P2G to be held in excess of the regulatory requirement and the P2R. Failure to comply with the P2R is a breach of own funds requirements and, accordingly, requires that the MFSA is notified immediately, providing a detailed capital plan on how the LSI intends to resolve the breach. Failure to comply with the P2G is not in itself a breach of own funds requirements, however,

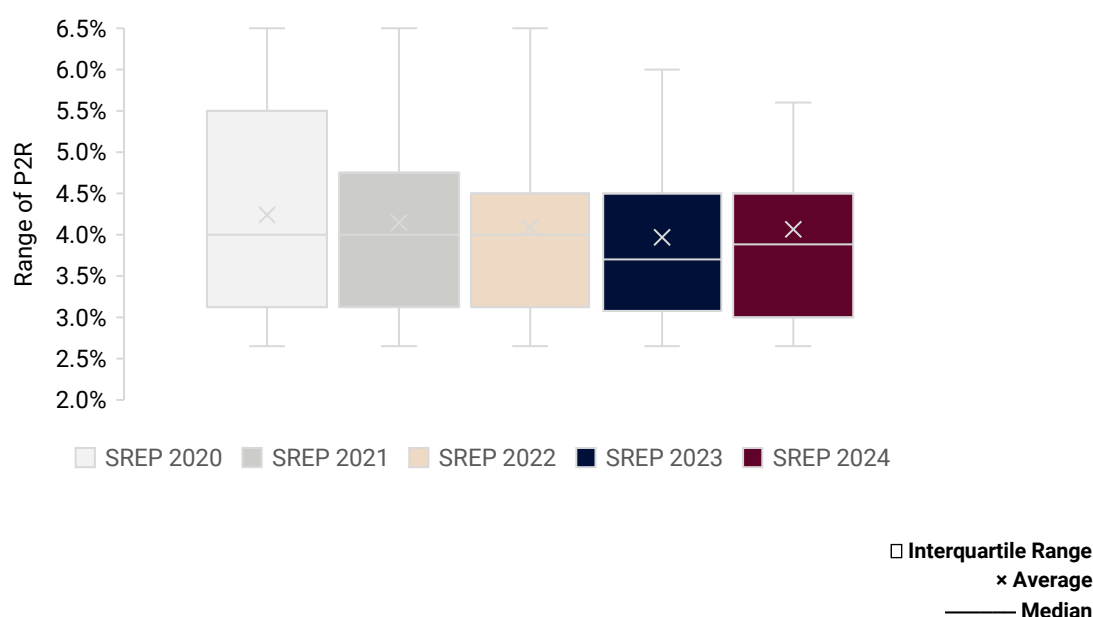
if the capital of the LSI falls, or is expected to fall, below the level of the P2G, the MFSA should be notified immediately. This notification should include a detailed explanation of the reasons for non-compliance as well as a comprehensive capital restoration plan specifying how and when the LSI intends to restore compliance with the P2G. The MFSA will then evaluate the situation and may impose further institution-specific measures as deemed necessary.

The Pillar 2 Requirement (P2R)

The MFSA's approach to the P2R involves a comprehensive assessment of the bank-specific risk profile across the various SREP dimensions. It is a critical mechanism for ensuring that credit institutions maintain adequate capital levels for risks not addressed by Pillar 1 capital allocations. The MFSA may further impose a P2R Governance add-on to capture significant weaknesses in the quality of the Board's oversight and of material and persistent deficiencies in high-level controls. This add-on is designed to ensure that LSIs not only meet quantitative capital thresholds but also maintain a strong governance framework that is essential for managing their operations and mitigating risks. Other add-ons, related to specific deficiencies, may also be imposed. These add-ons may be reduced or removed out of the SREP cycle if the deficiencies upon which they have been designed improve significantly and in a sustained manner, and to the satisfaction of the MFSA.

The MFSA has observed that, overall, LSIs adhere to the P2R. The average P2R has improved year-on-year, which is consistent with the slightly improved overall SREP score [Figure 14].

Figure 14: P2R Interquartile Range



NOTE: This chart includes the P2Rs of all LSIs subject to SREP. In the year of no SREP, the applicable P2R is considered for the purpose of assessing trends. This chart excludes P2Rs for those credit institutions that have since surrendered their banking licence.

The Pillar 2 Guidance (P2G)

During COVID-19, the ECB established a 1% floor for P2G, as a measure to ensure that banks maintained a minimum level of capital resilience during a period of significant economic uncertainty and

profitability pressures. This decision was part of broader efforts to provide banks with temporary relief while still safeguarding the stability of the financial system. As economic conditions stabilised, the need for such measures diminished, prompting a shift away from the uniform 1% P2G floor towards a more tailored approach based on individual risk profiles.

The MFSA has adopted a P2G Calibration Framework that considers a range of factors around banks' stress testing analysis to accurately assess the appropriate level of capital guidance for each institution. This framework is designed to ensure that capital buffers are commensurate with the specific risk exposures and vulnerabilities faced by individual banks, thereby enhancing their resilience in the face of potential adverse developments.

A key consideration in the P2G calibration process is the severity of the potential stress scenarios that the institution might encounter. The MFSA evaluates the impact of these scenarios on the bank's capital position, focusing on the extent of capital depletion under both baseline and adverse conditions. This analysis enables the identification of vulnerabilities that may not be adequately covered by existing capital buffers, ensuring that the P2G reflects the true risk profile of the institution.

In addition to the quantitative assessment of capital depletion, the governance framework surrounding stress testing plays a critical role in the P2G determination. The MFSA considers the robustness of the bank's internal governance processes, including the effectiveness of its risk management and internal control mechanisms, as well as the quality of its decision-making and oversight functions. Where weaknesses are identified in the governance of stress testing, institutions may be subject to high P2G requirements to reflect the additional risks posed by such deficiencies. The governance-related weaknesses identified in stress testing do not lead to an increase in P2R, thereby preventing any overlap or double counting between P2R and P2G.

The overall calibration of the P2G also considers the institution's strategic planning and capital management practices. This includes an evaluation of the bank's ability to generate and retain capital, its contingency planning for capital shortfalls, and its approach to maintaining capital adequacy under varying economic conditions. By incorporating these elements, the MFSA's P2G framework aims to provide a comprehensive and forward-looking assessment of the institution's capital resilience.

The move away from the 1% P2G floor marks a return to a more differentiated and risk-sensitive approach, allowing the MFSA to impose guidance that better aligns with the specific circumstances and risk profiles of individual banks. This tailored calibration supports the overall stability of the financial system by ensuring that the credit institutions are equipped with adequate capital buffers to withstand potential shocks, while also recognising improvements in their governance and risk management frameworks.

For 2023-24, the average P2G was that of 1.58%, slightly down from the average of 1.63% in 2022-23. The MFSA's P2G Calibration Framework continues to represent a dynamic approach to capital guidance, one that balances the need for resilience with the flexibility to adapt to evolving risks and economic conditions.

4.0 SUPERVISORY STRATEGY AND PRIORITIES

The MFSA published its Strategic Statement in January 2025, to provide external stakeholders with an interim review of the achievements and ongoing initiatives set under its release of 2023, aimed at fulfilling its statutory responsibilities in alignment with the mission and vision. The strategy guides the MFSA's business plans and priorities whilst incorporating considerations from the European Supervisory Authorities ("ESAs") and the ECB, ensuring alignment with broader European supervisory frameworks.

The strategic objectives are organised under five key pillars, namely:

- Delivering agile and proactive regulation that involves enhancing operational efficiency, increasing supervisory effectiveness, and maintaining independence
- Sustaining a resilient, internationally networked financial sector in which the MFSA aims to proactively engage with other regulators and stakeholders while combating financial crime
- Promoting good governance and compliance with a particular focus on establishing durable corporate governance programs and launching compliance initiatives to maintain confidence levels
- Embracing innovation to adapt to evolving business models and developments in sustainable and digital finance; and
- Engaging with the public through regular stakeholder engagement to reinforce the implementation of strategic priorities.

The MFSA's strategy embodies a comprehensive approach to ensuring financial stability, market integrity, and consumer protection, while remaining flexible in the face of a rapidly changing financial landscape. For more detailed information, please refer to the MFSA's Strategic Statement available on the Authority's website.^{7 8}

Whilst the strategic statement identifies the high-level areas on which the MFSA is focused to deliver its statutory obligations in line with its mission and vision, this document sets out further detail on the main supervisory and regulatory priority areas for the upcoming years.

The MFSA has introduced Compliance Outcomes-Based Supervision in 2024, through a three-year pilot project involving three supervisory functions, namely FinTech Supervision, Supervisory ICT Risk &

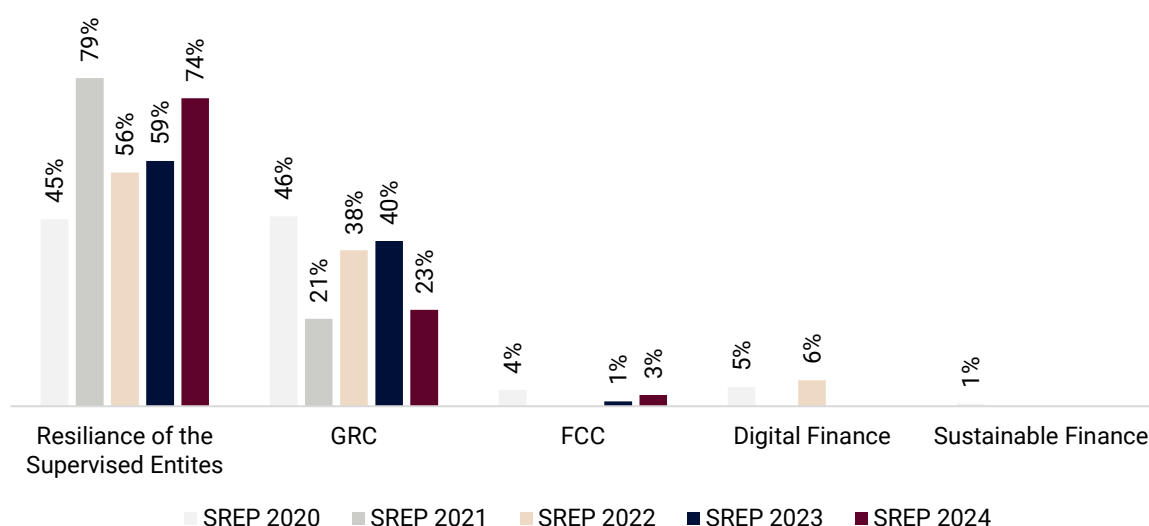
⁷ Malta Financial Services Authority, 'Strategic Update 2024: Securing Our Future as a Resilient and Efficient Jurisdiction' (2025). Available at <https://www.mfsa.mt/wp-content/uploads/2025/01/MFSA-Strategic-Update-2024-Securing-Our-Future-as-a-Resilient-and-Efficient-Jurisdiction.pdf>, accessed 11.06.2025

⁸ Malta Financial Services Authority, 'Strategic Statement (2023 – 2025): Securing Our Future as a Resilience and Efficient Jurisdiction' (2023). Available at <https://www.mfsa.mt/wp-content/uploads/2023/02/MFSA-Strategic-Statement.pdf>, accessed 12.06.2026

Cybersecurity and Trustees Supervision. This approach focuses on the intended results of supervisory interactions and enhances the MFSA’s risk-based supervision model. It prioritises entities that pose the highest potential impact on financial stability and consumer protection, applying structured interaction plans guided by proportionality. The ongoing supervisory priorities, which are considered crucial in the context of the MFSA’s day-to-day processes, include GRC, FCC and Consumer Protection & Education. Furthermore, the MFSA considers four additional high-level supervisory priorities for Banking Supervision to achieve its collective aim, being the resilience of supervised entities, sustainable finance, digital finance, and cross-border supervision. These initiatives align with MFSA’s 2023 Strategic Statement, aiming for a proactive and resilient financial sector.⁹

The SREP assessment feeds into addressing the MFSA’s Supervisory Priorities [Figure 15]. To-date the majority of supervisory measures have addressed institutions’ resilience and GRC.

Figure 15: MFSA’s Supervisory Priorities vis-a-vis SREP Supervisory Measures



NOTE: 2020 SREP values are based on 9 decisions, 2021 SREP on 2 decisions, 2022 SREP on 4 decisions, 2023 SREP on 5 decisions and 2024 SREP on 4 decisions. This chart excludes SREPs undertaken for those credit institutions that have since surrendered their banking licence.

In terms of credit institutions’ resilience, further focus has been put upon their monitoring arrangements around credit risk and their capital adequacy, in accordance with regulatory requirements. Stress testing design and scenario analysis have also been focal points in recent years. Credit institutions’ preparedness to emerging risk areas, such as climate and environmental (“C&E”), and how these will be embedded into their governance and risk management approach, will also be assessed and eventually featured in SREP. In its recent work on banks’ preparedness towards the changes in the new banking package, the MFSA sought not only to enhance the banks’ awareness of their compliance status regarding CRR III and CRD VI requirements, but also to identify and address any potential gaps

⁹ Malta Financial Services Authority, ‘Supervision Priorities 2025’ (2025). Available at: <https://www.mfsa.mt/wp-content/uploads/2025/02/MFSA-Supervisory-Priorities-2025.pdf>, accessed 12.06.2025

to ensure full regulatory compliance.¹⁰ This proactive approach is part of a broader effort to enhance the resilience of the financial sector, ensuring a harmonised regulatory evolution that fosters stability and compliance across the banking industry. By combining qualitative and quantitative insights, the MFSA underscored the importance of a smooth transition to CRR III, reinforcing the regulatory framework and strengthening financial stability.

On GRC, the MFSA has released the Corporate Governance Code for the entities it authorises, aiming to enhance governance throughout Malta's financial sector. The Code includes principles and supporting provisions and seeks to strengthen the legal, institutional, and regulatory framework for good governance in the Maltese financial services industry. In addition, the MFSA published Banking Rule BR/24 that focuses specifically on the internal governance arrangements and process that banks must implement to ensure their effective and prudential management. This Banking Rule is following the EBA Guidelines on Internal Governance under the CRD. The MFSA aims to continue steering banks' board members and their general practices towards the optimal governance frameworks and plans to publish other related material in the near future.

Financial Crime Compliance is a key priority for the MFSA, as ML-FT risk remains prominent in the financial sector. In addressing this risk, the MFSA has a dedicated Financial Crime Compliance Function, which works in close collaboration with Banking Supervision and other supervisory functions to address these risks. Furthermore, the MFSA collaborates with the FIAU to ensure compliance with AML-CFT obligations and sanctions regulations, mitigating financial crime risks in Malta. AML-CFT is integrated into both the authorisation and supervision processes of the MFSA, focusing on areas like conflict-of-interest management, board involvement, and risk awareness among senior management. This approach has helped identifying governance issues and enabled swift corrective actions. The MFSA prioritises information sharing and compliance examinations, following EU-wide guidelines.

The Supervisory ICT Risk and Cybersecurity ("SIRC") function will be instrumental in advancing the MFSA's strategic priority on digital finance. As the financial sector continues investing and evolving its digitalisation efforts, SIRC will serve as a key enabler of secure innovation and regulatory agility. SIRC will support the development of forward-looking regulatory approaches that aid technological shifts and emerging cyber threats, ensuring that the MFSA remains responsive and adaptive. By fostering strong international partnerships and intelligence-sharing networks, SIRC will contribute to a more resilient and globally integrated financial ecosystem. In parallel, SIRC will reinforce governance standards by guiding Authorised Persons in embedding robust ICT risk management and cybersecurity frameworks, thereby strengthening compliance and operational integrity. As innovation accelerates, SIRC will play a key role in assessing the risks and opportunities of emerging technologies, helping the MFSA strike a balance between fostering innovation and safeguarding financial stability. Public engagement will also be a priority, with the function contributing to awareness initiatives that promote digital trust and empower consumers to navigate the digital finance landscape securely. Through these efforts, the SIRC will not only protect the financial sector from evolving threats, but also position Malta as a forward-thinking jurisdiction that embraces digital finance with confidence and resilience.

¹⁰ Malta Financial Services Authority, 'Dear CEO Letter on Preparedness to Upcoming Change in the Capital Requirements Regulation: Industry-Wide Survey'. Available at <https://www.mfsa.mt/wp-content/uploads/2024/06/Preparedness-to-Upcoming-Changes-in-the-Capital-Requirements-Regulation-CRR-Industry-Wide-Survey.pdf>, accessed 26.05.2025

The MFSA is increasing scrutiny on C&E risks, ensuring credit institutions adopt sustainable business models and prevent/avoid greenwashing. The MFSA is also providing updates and guidance to the market on developments in sustainable finance, aiming to support a smooth transition towards a greener economy.

The Banking Supervision Function prioritised outreach to credit institutions to address this priority. A 'Dear CEO' letter was issued in November 2022, whereby banks were requested to assess their preparedness to the C&E provisions in the new Banking Package.¹¹ The MFSA expected banks to evaluate these risks, integrate them into their risk management frameworks, and improve transparency through appropriate disclosures. Banks were also expected to provide training to key personnel and integrate climate-related metrics into their internal policies and remuneration frameworks. The MFSA set clear deliverables for 2023, requiring banks to show measurable progress, including a presentation on their progress. The overall goal was to ensure that banks in Malta were equipped to manage climate and environmental risks effectively and meet regulatory requirements under upcoming European frameworks, such as CRD VI. Following a comprehensive review of LSIs' C&E risk management practices, the MFSA identified key areas for improvement, particularly in assessing the interconnectedness of C&E risks with traditional financial risks. Another 'Dear CEO' letter, dated 7 January 2025, was issued in this respect. The letter urged banks to conduct a comprehensive gap analysis to evaluate their readiness against the findings and, more broadly, against the ECB expectations, as well as to develop a remediation plan approved by the Board of Directors outlining specific, actionable measures with defined timelines for implementation.¹² The MFSA is currently assessing the credit institutions' replies and a feedback letter will be provided in due course.

¹¹ Malta Financial Services Authority, 'MFSA's Expectations in relation to Sustainable Finance Requirements' (2022). Available at: <https://www.mfsa.mt/wp-content/uploads/2023/09/Dear-CEO-Letter-MFSAs-Expectations-in-relation-to-Sustainable-Finance-Requirements.pdf>, accessed 22.06.2025

¹² Malta Financial Services Authority, 'Dear CEO Letter on MFSA 2023/2024 Thematic Review on the Identification and Management of Climate-Related and Environmental Risks by LSIs in Malta. Available at: [Dear-CEO-MFSA-2023_2024-Thematic-Review-on-the-Identification-and-Management-of-Climate-Related-and-Environmental-Risks-by-LSIs-in-Malta.pdf](#), accessed 23.06.2025

5.0 BENCHMARKING WITH THE REST OF THE SSM

On 13 December 2024, the ECB published its biennial report on the supervision of LSIs. The publication captures developments across 1,928 LSIs (or 16% of total banking assets in Europe) in the reference period Q42021 to Q42023 and provides an analysis of the structural features of the LSI sector within the SSM, its key developments and major supervisory activities aimed at addressing challenges from the NCAs' perspective.¹³

The LSIs in Member States participating in the SSM vary greatly in terms of number, size of assets and business model and, accordingly, this has implications for the comparability of LSI country aggregates. At the time of writing this publication, the Maltese banking sector covered by SREP was comprised of 17 credit institutions, of which 14 are classified as LSIs in accordance with the ECB Methodology.¹⁴ LSIs in Malta have diverse business models, each posing varying levels of complexity and sophistication in their operating and commercial models. Nonetheless, the overarching situation is that SSM LSIs have exhibited resilience in the face of the recent economic turbulence, having achieved sound profitability ratios coupled with robust capital and liquidity positions. The threats to the banking sector continue to be apparent amongst LSIs as a result of the fast-paced evolution of the economic landscape, driven by increased uncertainties from global geopolitical and macroeconomic tensions, but also the high competition and pressure to modernise the business of banking. The strong capital levels seem to aid LSIs in addressing the current challenges. However, adequate buffers need to be maintained to ensure that banks can master possible increased cost of risk and funding, alongside the need to adapt to the evolving operational infrastructure.

This report also puts emphasis on the necessity for NCAs to focus on clear supervisory priorities aimed at addressing the key risks, whilst undertaking a risk-focused approach towards the LSIs. Proportionality also plays an essential role in the conduct of supervisory work, taking into consideration the risk profile, business model and size of each bank, without compromising prudential oversight. The classification regime represents the starting point when applying proportionality - a principle that has also been adopted by the MFSA as aforementioned.

Moving ahead, the direct supervision by the NCAs, as well as oversight by the ECB on LSIs, will continue to focus on the required changes in areas portraying key vulnerabilities whilst putting in place adequate incentives. The MFSA continues to be part of various EBA and ECB work streams to facilitate the monitoring and benchmarking of, and improvements in LSI-specific and sector-wide supervisory practices, with the overall aim to keep risks within the banking sector contained and mitigated.

¹³ European Central Bank, 'LSI Supervision Report' (2024). Available at: <https://www.bankingsupervision.europa.eu/ecb/pub/html/LSIreport/ssm.LSIreport2024~b8dd7cda4f.en.html>, accessed 02.08.2025

¹⁴ European Central Bank, 'What Makes a Bank Significant?'. Available at: <https://www.bankingsupervision.europa.eu/framework/supervised-banks/criteria/html/index.en.html>, accessed 02.08.2025

On 17 December 2024, the ECB published its aggregated results of the 2024 SREP, with the aim of showcasing its observations of the euro area banks it supervises.¹⁵ These publications, amongst others, continue to enhance regulatory transparency aimed at ensuring a consistent application of supervisory standards within the EU's financial system.

¹⁵ European Central Bank, 'Aggregated Results of the 2024 SREP' (2024). Available at: https://www.bankingsupervision.europa.eu/activities/srep/2024/html/ssm.srep202412_aggregatedresults2024.en.html, accessed 02.08.2025

6.0 REGULATORY DEVELOPMENTS AND STRATEGIC IMPERATIVES

Credit institutions may face both near-term macro-financial risks and medium-term challenges. The current geopolitical risks and increased reliance on critical third-party ICT providers raise concerns due to the rising operational and cyber risks. Consequently, credit institutions must address structural inadequacies in their outsourcing arrangements and strengthen their IT security and cyber resilience frameworks.

The MFSA started preparing the industry as early as 2023, when most of its Supervisory Engagements related to ICT and cybersecurity were conducted using the controls applicable at the time, such as the MFSA and EBA Guidelines, and their corresponding DORA equivalents. Credit institutions were also encouraged to present remedial plans which were in line with DORA rather than the existing instruments. In 2024, the MFSA identified DORA Preparedness as one of its supervisory engagements outcomes that sought to gauge the level of preparations that were being made by the industry in preparation of DORA becoming applicable.¹⁶ In 2025, the Authority introduced new supervisory tools to measure DORA compliance such as Cyber Resilience Stress Testing Exercises, a redesigned ICT Risk Questionnaire, and controls aimed at measuring ICT TPPs' and contractual arrangements' performance. In 2025, the SIRC function issued a Dear CEO Letter to the public, outlining its key observations noted during its 2024 Supervisory Engagements.¹⁷ The letter is divided into two parts, where the first part details observations stemming from Supervisory Engagements conducted using Outcomes-based approach, and the second part focusing on Supervisory Engagements conducted using other methodologies.⁹

Overall, the MFSA acknowledges the significant strides made by the credit institutions throughout the years, especially the growing emphasis on enhancing digital operational resilience. The progress observed demonstrates a forward-thinking approach within this sector by implementing the necessary structures, safeguards, and competencies to align with regulatory expectations. The MFSA expresses its sincere appreciation to all Licence Holders who dedicated their time, resources, and knowledge in facilitating the Authority's Supervisory activities. This shared commitment highlights the sector's increasing awareness of the vital importance of securing ICT systems and ensuring business continuity in a progressively digital financial environment.

The MFSA encourages credit institutions to continue investing in ICT and cybersecurity not only to ensure compliance with DORA but also to strengthen the overall performance of the sector as a whole. In the coming years, the Authority remains committed to engaging with credit institutions in a meaningful and prudent manner, with a focus towards a collaborative approach concerning DORA compliance which includes input from the regulators, credit institutions, their ICT TPPs, and industry-wide stakeholders. For this reason, the Authority encourages credit institutions to broaden their scope where digital operational resilience is concerned and considers modern technologies which will change

¹⁶ Malta Financial Services Authority, 'Dear CEO Letter on The Authority's Minimum Expectations in Relation to Financial Entities' Preparedness to Regulation (EU) 2022/2554 on DORA' (2024). Available at: [Dear-CEO-Letter-The-Authoritys-Minimum-Expectations-in-Relation-to-Financial-Entities-Preparedness-to-Regulation-EU-20222554-on-DORA.pdf](#), accessed 08.07.2025

¹⁷ Malta Financial Services Authority, 'Dear CEO Letter on Supervisory Engagements and Digital Operational Resilience 2024' (2025). Available at: [Dear-CEO-Letter-Supervisory-Engagements-and-Digital-Operational-Resilience-2024.pdf](#), accessed on 26.10.2025

how everyone operates and uses technologies. For instance, this includes artificial intelligence and quantum computing.

Apart from DORA readiness, credit institutions should further effectively identify, assess, and manage climate-related and environmental risks, whilst transparently disclosing their exposures. CRR III and CRD VI introduce measures to integrate ESG risks into the prudential framework of credit institutions. These changes require institutions to embed ESG risks into their risk management frameworks, governance structures, stress testing procedures, and reporting systems. The MFSA has adopted a proportionate approach, allowing LSIs to gradually incorporate these risks. Through ongoing engagement with credit institutions and their management, the MFSA has provided guidance on how to align with ESG requirements, which will eventually be incorporated in SREP, ensuring compliance with the implementation timelines of CRD VI. The full integration of the ESG risk framework is expected between 2026 and 2027. Beyond 2027, the regulatory framework is expected to evolve further as more data becomes available, and ESG risk management practices continue to mature alongside increased supervisory work in this area.

The compliance with the evolving ITS for regulatory reporting and disclosure is not only a regulatory necessity but also a critical step towards enhancing transparency, consistency, and accuracy in financial reporting practices across the sector. The upcoming releases of the supervisory reporting framework will introduce a series of substantial changes that will directly impact several key areas, including CRR III/CRD VI-related reporting requirements, Markets in Crypto-Assets Regulation (“MiCAR”) supervisory reporting and Pillar 3 disclosures. Further amendments will bring the integration of important elements such as DORA ITS and diversity benchmarking templates into the Data Point Model and the corresponding taxonomy. Given the complexity and breadth of these changes, it is imperative that credit institutions take a proactive approach to preparation. A diligent and forward-looking approach will be key to mitigating potential challenges and maintaining the high standards of reporting expected within the financial sector.

Furthermore, the anticipated implementation of CRR III and CRD VI has introduced new regulatory requirements, necessitating proactive adaptation to maintain regulatory compliance and sustain competitive positioning. In this regard, on 5 June 2024, the MFSA issued a Dear CEO Letter to assess the preparedness of credit institutions for the upcoming changes in the banking package.¹⁸ The initiative was aimed at evaluating the extent to which banks are aligning with the new CRR III and CRD VI requirements, which took effect on 1 January 2025 and 9 July 2024, respectively.

The MFSA evaluated compliance with the revised regulatory framework, with the aim of ensuring that banks have implemented the necessary operational mechanisms, governance structures, and competencies to meet the updated requirements. Further assessment was performed on the impact of the revised capital requirements vis-a-vis CRR II, with information gathered on, *inter alia*, the overall capital requirements, as well as capital requirements in relation to credit risk, operational risk, market

¹⁸ Malta Financial Services Authority, ‘Dear CEO Letter on Preparedness to Upcoming Changes in the Capital Requirements Regulation (CRR): Industry-Wide Survey’ (2024). Available at: [Preparedness-to-Upcoming-Changes-in-the-Capital-Requirements-Regulation-CRR-Industry-Wide-Survey.pdf](#), accessed 14.08.2025

risk, leverage ratio and securitisation under the Standardised Approach. A feedback letter was issued on 25 March 2025, offering a comprehensive overview of the readiness of Maltese banks.¹⁹

These evolving standards and regulations underscore the need for credit institutions to continually adapt their strategies and operations to meet regulatory expectations and mitigate emerging risks. The MFSA will continue to ensure regulatory transparency is maintained and hereby urges credit institutions to follow the Authority's communications, including circulars, instructions and guidance documents, among others. These resources are essential in helping credit institutions to navigate the regulatory updates effectively and ensure timely compliance.

¹⁹ Malta Financial Services Authority, 'Dear CEO Letter providing Feedback letter on the findings of the industry-wide survey on the banks' preparedness to the changes in the Capital Requirements Regulation' Available at: [Dear-CEO-Letter-Feedback-Letter-on-the-Findings-of-the-Industry-Wide-Survey-on-the-Banks-Preparedness-to-the-Changes-in-the-Capital-Requirements-Regulation.pdf](#), accessed 14.08.2025

7.0 CONCLUDING REMARKS

The SREP aims to produce an overall view of the credit institutions' risk profile that is as complete as possible, taking into account all relevant risks and their possible mitigants. A credit institution's risk profile is inevitably multifaceted, with risks being interrelated. With this in mind, the MFSA takes a holistic approach to assessing the SREP elements and, in producing its overall SREP outcome.

The SREP Decision often points out shortcomings and, imposes capital requirements and qualitative measures aimed at addressing them. Along the years, the MFSA has observed notable improvements and good practices adopted by credit institutions, which demonstrate that the key elements for a resilient financial system are already being implemented. Amongst the improvements, the MFSA notes the improved governance structures and risk culture that set stronger foundations before considering further growth or new ventures. On the business model front, credit institutions have enhanced the reliability of their projections and their focus on delivering a clear capital planning process with links to budgeting and strategic planning. The enhanced stress testing framework and integration into strategy are also of note.

These improvements are a continuum. The MFSA understands that the integration of the local banking sector within the broader European financial landscape may present distinctive opportunities, but also challenges, in particular to smaller credit institutions. Nonetheless, banks must navigate through these dynamics with rigorous risk management practices tailored to the plethora of evolving regulatory standards.

The MFSA is highly committed to continue to work closely with its licensed entities and other stakeholders to ensure clarity around its expectations, whilst understanding their challenges, through its annual engagements and industry outreach. The MFSA shall also remain committed to applying the principle of proportionality, *inter alia*, through SREP, ensuring that supervisory measures are commensurate with the nature, scale and complexity of the credit institution's risk profile.

The MFSA looks forward to continuing its efforts aimed at strengthening financial resilience in years to come.