MFSA MALTA FINANCIAL SERVICES AUTHORITY

1 September 2026

Banking Supervision Office
Tel: (356) 2144 1155

Dear Chief Executive Officer,

Re: Compliance Outcomes-Based Supervision
– **Internal Capital Adequacy Assessment Process ('ICAAP') and Stress Testing Capabilities**

The Malta Financial Services Authority ('MFSA' or 'the Authority') is issuing this letter to Chief Executive Officers of credit institutions to communicate the key outcomes of its recent supervisory assessment of the ICAAP and stress testing frameworks across a sample of Less Significant Institutions ("LSIs").

This communication forms part of the MFSA's Compliance Outcomes-Based Supervision approach and builds on the Authority's ongoing supervisory engagement with institutions, including its recent thematic work on the Internal Liquidity Adequacy Assessment Process ('ILAAP').[1] It is intended to provide institutions with insight into observed practices, identified areas for enhancement, and the Authority's expectations in relation to ICAAP and stress testing capabilities.

The assessment identified that, while all institutions have established foundational stress testing frameworks, the level of alignment with supervisory expectations varies across institutions and key components of the framework. In particular, the Authority observed a recurring divergence between institutions' self-assessed levels of compliance and the outcomes of the MFSA's supervisory assessment, based on the Authority's review of supporting documentation and evidence. This divergence is primarily driven by the extent to which frameworks are formally documented, consistently applied, and effectively embedded within governance, risk management, and decision-making processes.

The review further highlighted that, although stress testing is generally implemented as part of the ICAAP process, its integration into governance arrangements, risk appetite setting, and strategic decision-making remains at an evolving stage in several institutions.

Institutions are encouraged to carefully consider the findings outlined in this letter and to take timely and effective action, where necessary, to address any relevant gaps and strengthen the overall robustness, credibility and usability of their ICAAP and stress testing frameworks.

1.0 BACKGROUND INFORMATION AND SCOPE

The MFSA continues to enhance its supervisory framework through the further implementation of its Compliance Outcomes-Based Supervision approach, which is now embedded across all supervisory functions. In doing so, and in line with the MFSA's Supervisory Priorities, the Authority is placing increased emphasis on ensuring that supervised entities deliver tangible and demonstrable regulatory outcomes, particularly in areas relating to governance, risk management, and financial resilience.[2]

Following the MFSA's recent supervisory engagement and Dear CEO letter dated 16 June 2026 covering the area of liquidity risk and the ILAAP, this review places particular focus on institutions' ICAAP and stress testing frameworks, recognising their critical role in supporting capital resilience under adverse conditions.[1]

Within this context, the ICAAP and the associated stress testing frameworks represent a key pillar of institutions' risk management and strategic planning frameworks. These frameworks are expected to provide a forward-looking view of capital adequacy, enabling institutions to assess their ability to withstand severe but plausible scenarios and to maintain adequate capital levels over the planning horizon.

In this regard, the MFSA undertook a targeted review of ICAAP and stress testing frameworks across a selected sample of LSIs. The selection followed a risk-based and proportionate approach, with the objective of assessing how effectively institutions have translated regulatory requirements and supervisory expectations into practice, and of identifying opportunities for enhancement in the design and application of these frameworks.

The assessment focused on five key areas:

i. Internal governance

ii. Scope and coverage of stress testing

iii. Scenario design and calibration

iv. Reverse stress testing, and

v. Application of stress testing outputs.

Institutions within scope were requested to complete a self-assessment of their level of alignment with applicable regulatory requirements and supervisory expectations, and to provide supporting documentation and remediation plans, where relevant. The MFSA subsequently conducted a desk-based review and supervisory challenge process to assess whether the reported outcomes were adequately substantiated, internally consistent, and reflective of each institution's risk profile and business model.

The assessment was conducted with reference to the applicable regulatory and supervisory framework governing ICAAP and stress testing, inter alia:

- Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation (EU) No 648/2012 (hereinafter 'Capital Requirements Regulation' or 'CRR');[3]
- MFSA Banking Rule BR/24 on Internal Governance of Credit Institutions;[4]
- MFSA Banking Rule BR/26 on Stress Testing Requirements of Credit Institutions;[5]
- the European Banking Authority Guidelines on ICAAP and ILAAP Information Collected for SREP purposes (EBA/GL/2016/10);[6]
- the European Banking Authority Guidelines on Institutions' Stress Testing (EBA/GL/2018/04);[7]
- the European Banking Authority Guidelines on Common Procedures and Methodologies for the SREP and Supervisory Stress Testing (EBA/GL/2022/03), March 2022; and[8]
- the European Central Bank Guide to the ICAAP, November 2018.[9]

Further to the above, the MFSA expects institutions to consider relevant international standards, supervisory guidance, and best practices, including the Basel Committee on Banking Supervision ('BCBS') Stress Testing Principles and the BCBS Principles for Effective Risk Data Aggregation and Risk Reporting (BCBS 239) [10], [11].

While this review was conducted on a selected sample of institutions, the MFSA is issuing this communication to set out supervisory expectations applicable to all credit institutions operating under the Banking Act, Chapter 371 of the Laws of Malta.

2.0 SUPERVISORY ASSESSMENT AND KEY FINDINGS

The findings of this review complement the observations communicated through the Authority's recent ILAAP targeted review and collectively contribute to the MFSA's understanding of institutions' overall resilience frameworks. Taken together, these exercises provide valuable insight into institutions' capacity to assess, manage, and withstand adverse conditions from both a capital and liquidity perspective.

The supervisory assessment provides a consolidated view of observed practices across the institutions within scope, highlighting both areas where institutions have established foundational ICAAP and stress testing capabilities and areas where further enhancement is warranted.

While the exercise was conducted on a selected sample of institutions, its outcomes are intended to serve as a useful benchmarking reference for all credit institutions. In particular, the assessment identified a recurring divergence between institutions' self-assessments and the MFSA's supervisory assessment, reflecting differing views on the extent to which stress testing frameworks are formally documented, effectively embedded, and demonstrably integrated into governance, risk management and decision-making processes.

Institutions are encouraged to assess their ICAAP and stress testing frameworks against the findings outlined in this letter as part of their ongoing efforts to strengthen resilience, enhance risk management capabilities, and support informed strategic decision-making. This assessment should help identify opportunities for improvement, address potential gaps, and further develop practices that are commensurate with the institution's risk profile and business model, while also taking into account applicable regulatory requirements and supervisory expectations.

2.1 Internal Governance

Internal governance is a fundamental component of an effective ICAAP and stress testing framework. In accordance with the EBA Guidelines on Institutions' Stress Testing (EBA/GL/2018/04, paragraphs 12, 20–31)[7] and the ECB Guide to the ICAAP (Principles 1 and 2)[9] , as reflected in MFSA Banking Rules BR/24[4] and BR/26[5], institutions are expected to establish governance arrangements that ensure stress testing is appropriately overseen, challenged, documented, and embedded within broader risk management and decision-making processes. The Board of Directors is expected to exercise effective oversight of the stress testing framework, while ensuring that responsibilities, controls, and review mechanisms support its ongoing effectiveness.

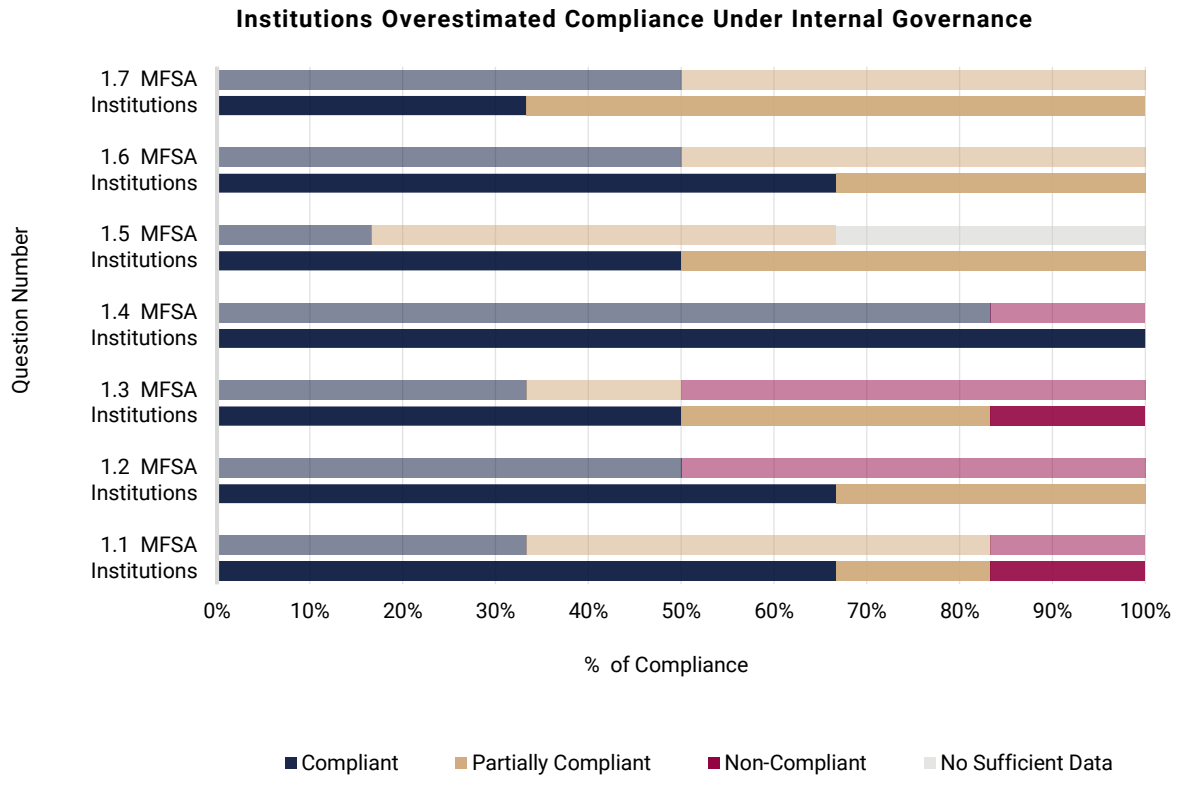

Figure 1: Internal Governance - Institutions' Self-Assessment versus MFSA Assessment

Note: The chart compares institutions' self-assessments with the MFSA's supervisory assessment. Solid colours represent institutions' self-assessment outcomes, whilst lighter shades of the same colour represent the MFSA's supervisory assessment. Across the areas reviewed, institutions generally reported higher proportions of '*compliant*' outcomes, while MFSA assessments shift classifications towards *'partially compliant*', '*non-compliant*' or *'no sufficient data'*.

Question References: (1.1) Governance Framework, Policies and Procedures; (1.2) Board Oversight and Accountability (1.3) Board Expertise and Challenge; (1.4) Resources and Expertise; (1.5) Data and IT Infrastructure; (1.6) Framework Review and Independent Challenge; (1.7) Internal Audit Assurance

The assessment indicates that institutions generally considered themselves to be compliant across most aspects of internal governance. In particular, institutions reported that stress testing frameworks are supported by governance arrangements that are proportionate to their size and complexity, with stress testing activities embedded within their ICAAP and subject to Board approval, oversight by senior management, and periodic review. Institutions also generally considered their resources, expertise, and governance structure to be adequate to support the effective execution of stress testing frameworks.

However, the MFSA's assessment identified several recurring gaps between institutions' self-assessments and supervisory expectations, particularly in relation to the formalisation and evidencing of governance arrangements. While Board approval of stress testing programmes was generally evident, the MFSA observed more limited evidence demonstrating active Board challenge of stress testing assump-

tions, scenario design, methodologies, and results. In addition, documentation supporting Board discussions, challenge, and follow-up actions was often insufficient to demonstrate ongoing oversight consistent with supervisory expectations.

The MFSA acknowledges that, particularly within institutions operating under proportionate governance arrangements, challenge and review may be exercised through governance structures that differ from those typically observed in larger and more complex institutions. This may include challenge exercised through the Risk Committee, whose membership may substantially overlap with that of the Board of Directors, supported by ongoing engagement between senior management and Board members. Nevertheless, institutions should be able to evidence that stress testing assumptions, methodologies, scenarios, results and proposed management actions have been subject to effective oversight and challenge, and that the Board has appropriately considered the outcomes when discharging its responsibilities.

The review further identified opportunities for enhancement in relation to the documentation of roles and responsibilities across the three lines model, the establishment of comprehensive stress testing policies and procedures, and the periodic review of the effectiveness of stress testing frameworks. While institutions generally reported that responsibilities had been assigned to relevant functions, supporting documentation did not always clearly evidence accountability, independent challenge, and the involvement of all relevant business and control functions throughout the stress testing lifecycle.

Furthermore, although Internal Audit reviews of the ICAAP were generally being performed, the scope and depth of such reviews did not always provide comprehensive assurance regarding the effectiveness of the end-to-end stress testing framework. In several instances, institutions were unable to demonstrate that Internal Audit had assessed the design, governance, implementation, and ongoing effectiveness of stress testing activities in a comprehensive manner.

SUPERVISORY EXPECTATIONS

The MFSA expects institutions to:

i. Establish robust and proportionate governance arrangements

ii. Maintain documented and periodically reviewed stress testing policies

iii. Demonstrate effective Board oversight and challenge

iv. Clearly define responsibilities and accountability across the three lines model

v. Ensure effective Internal Audit assurance

vi. Maintain sufficient expertise and resources

While governance arrangements may vary in line with the principle of proportionality, institutions should be able to demonstrate that such arrangements support effective oversight, challenge, accountability, and decision-making.

2.2 Scope and Coverage

An effective stress testing framework should capture all material risks and provide a forward-looking assessment of the institution's resilience under adverse conditions. In accordance with MFSA Banking Rule BR/26[5], the EBA Guidelines on Institutions' Stress Testing (EBA/GL/2018/04, paragraphs 47-55 and 189)[7], and the ECB Guide to the ICAAP (Principles 3, 4 and 7)[9], institutions are expected to maintain comprehensive and proportionate stress testing frameworks aligned to their risk profile and business model, covering material risks, concentrations, interdependencies, and capital adequacy.

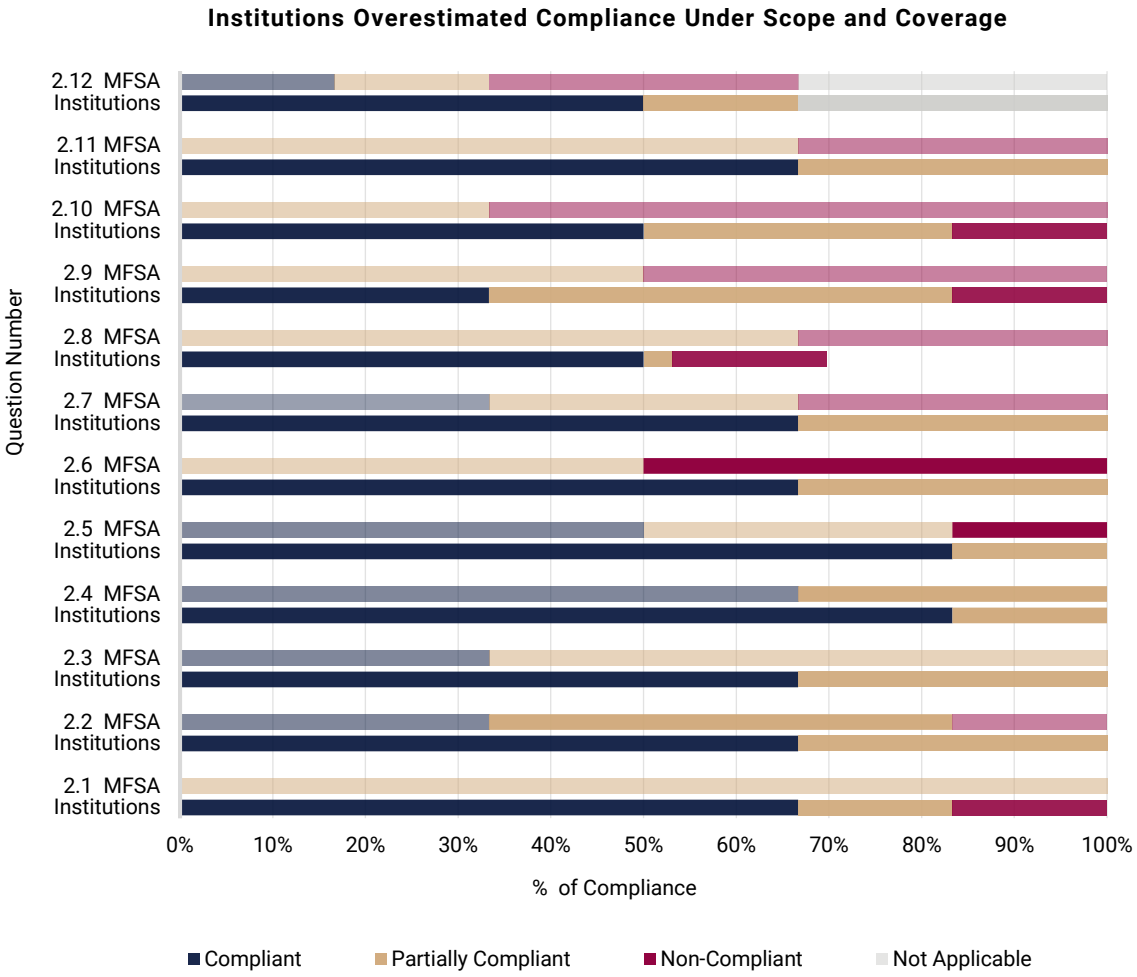

Figure 2: Scope and Coverage - Institutions' Self-Assessment versus MFSA Assessment

Note: The chart compares institutions' self-assessments with the MFSA's supervisory assessment. Solid colours represent institutions' self-assessment outcomes, whilst lighter shades of the same colour represent the MFSA's supervisory assessment. Across the areas reviewed, institutions generally reported higher proportions of '*compliant*' outcomes, while MFSA assessments shift classifications towards *'partially compliant*' and '*non-compliant*'.

Question References: (2.1) Stress Testing Objectives and ICAAP Integration; (2.2) Material Risks and Risk Inventory Coverage; (2.3) Proportionality and Institution-Wide Coverage; (2.4) Time Horizon and ICAAP Alignment; (2.5) Credit and Counterparty Credit Risk; (2.6) Operational Risk; (2.7) Market Risk; (2.8) IRRBB; (2.9) Climate Risk; (2.10) Concentration Risk; (2.11) Solvency-Liquidity Linkages and Feedback Effects; (2.12) Commercial Real Estate Exposures

The assessment indicates that institutions generally considered their stress testing frameworks to be appropriately aligned with their risk profile, business model and ICAAP framework. Institutions reported that material risks were identified through established risk inventories and that stress testing exercises covered the key risk categories relevant to their activities. Institutions also generally considered their stress testing programmes to be proportionate to their size and complexity and that stress testing was performed across both institution-wide and risk-specific dimensions.

However, the MFSA's assessment identified a number of areas where the scope and coverage of stress testing frameworks could be further strengthened. While institutions generally demonstrated coverage of core risk categories, the extent to which stress testing frameworks comprehensively captured all material risks, risk interdependencies, and emerging vulnerabilities was not always sufficiently evidenced. In several instances, institutions were unable to clearly demonstrate how stress testing outputs were linked to their broader risk inventories or how material risks were translated into scenario design, stress testing assumptions, and capital planning assessments.

The review further identified varying levels of maturity in the incorporation of both the normative and economic perspectives within stress testing frameworks. While most institutions demonstrated the use of stress testing for assessing regulatory capital adequacy under adverse conditions, the economic perspective was not always clearly articulated or sufficiently reflected within stress testing methodologies and supporting documentation. In addition, institutions often relied on broad macroeconomic or externally prescribed adverse scenarios. While such scenarios provide a valuable benchmark, institutions did not always demonstrate that stress testing frameworks adequately reflect institution-specific vulnerabilities arising from business model, operating environment, portfolio composition, sectoral exposure, geographic concentrations, and other material risk drivers. As a result, stress testing did not always provide a comprehensive assessment of resilience, from both a normative and economic perspective.

Opportunities for enhancement were further identified in relation to the assessment of concentration risk, the consideration of second-round effects, and the interaction between solvency and liquidity stress testing. While institutions generally reported that such risks and interdependencies were considered as part of the stress testing process, the underlying methodologies, supporting assumptions, and documented assessments were not always sufficiently developed to demonstrate a comprehensive institution-wide view of risk.

In addition, the incorporation of emerging risk drivers within stress testing frameworks remains at varying stages of maturity across institutions. In particular, the MFSA observed differing approaches in relation to the consideration of environmental and climate-related risks, with some institutions demonstrating only limited integration of such risks within adverse scenario analysis and forward-looking capital adequacy assessments.

The MFSA acknowledges that the scope and complexity of stress testing frameworks should reflect the principle of proportionality and be commensurate with the nature, scale, and complexity of an institution's activities. Nevertheless, while proportionality may influence the complexity of methodologies employed, it should not result in the omission of material risks from the stress testing framework. Institutions are expected to ensure that all material risks are appropriately identified, assessed, and reflected within their stress testing programme.

SUPERVISORY EXPECTATIONS

The MFSA expects institutions to:

i. Define clear stress testing objectives aligned to the risk management frameworks
ii. Ensure all material risks are approporiately captures within stress testing exercises
iii. Maintain consistency between risk inventories and stress testing coverage
iv. Assess concentration risk and risk interdependencies on an institution-wide basis
v. Consider solvency-liquidity interactions and second-round effects, where relevant
vi. Incorporate emerging and climate-related risks into stress testing frameworks

While the scope and complexity of stress testing frameworks may vary in line with the principle of proportionality, institutions should be able to demonstrate that all material risks have been comprehensively assessed and appropriately reflected within their stress testing programme.

2.3 Scenario Design and Calibration

An effective stress testing framework should be supported by robust scenario design and calibration processes that enable institutions to assess their resilience under severe but plausible adverse conditions. In accordance with MFSA Banking Rule BR/26[5], the EBA Guidelines on Institutions' Stress Testing (EBA/GL/2018/04, paragraphs 72–83)[7], and the ECB Guide to the ICAAP (Principles 3, 4 and 7)[9], institutions are expected to develop forward-looking scenarios that reflect material risks, institution-specific vulnerabilities, and an appropriate degree of severity, while ensuring that stress testing outputs provide a meaningful assessment of capital adequacy and resilience.

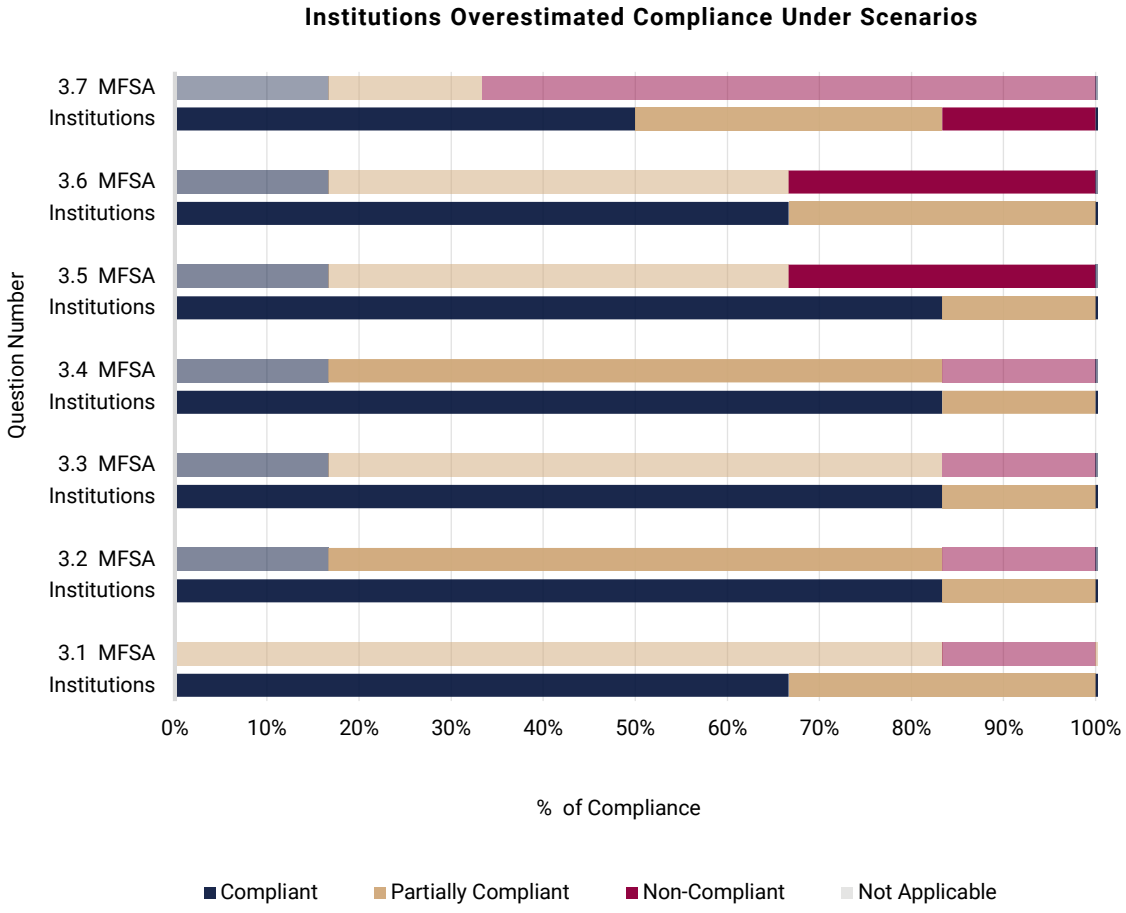

Figure 3: Scenario Design and Calibration - Institutions' Self-Assessment versus MFSA Assessment

Note: The chart compares institutions' self-assessments with the MFSA's supervisory assessment. Solid colours represent institutions' self-assessment outcomes, whilst lighter shades of the same colour represent the MFSA's supervisory assessment. Across the areas reviewed, institutions generally reported higher proportions of '*compliant*' outcomes, while MFSA assessments shift classifications towards *'partially compliant*' and '*non-compliant*'.

Question References: (3.1) Scenario Design Governance and Application; (3.2) Scenario Narratives and Risk Factor Coverage; (3.3) Range and Severity of Scenarios; (3.4) Forward-Looking Scenario Design and Data Usage; (3.5) Scenario

The assessment indicates that institutions generally considered their scenario design and calibration practices to be appropriate for their risk profile and business model. Institutions reported that scenario analysis formed an integral part of their stress testing programmes and that scenarios incorporated a combination of macroeconomic, financial market, and institution-specific risk factors. Institutions also generally considered their scenario design processes, calibration approaches, and governance arrangements to be sufficiently robust to support capital planning and risk management objectives.

However, the MFSA's assessment identified several areas where scenario design and calibration frameworks could be further strengthened. While institutions generally demonstrated the use of adverse scenarios, supporting documentation did not always clearly demonstrate how scenarios were developed, calibrated, challenged, approved, and periodically reviewed. In several instances, institutions were unable to evidence a formal and sufficiently documented process linking identified vulnerabilities, material risks, and stress testing objectives to scenario selection and calibration. The review also identified instances where scenario design and calibration activities were heavily concentrated within a limited number of functions, with insufficient involvement of independent control functions and limited evidence of structured challenge across the three lines of defence.

The review further identified opportunities for enhancement in relation to the design of institution-specific scenarios and the incorporation of material vulnerabilities arising from the institution's business model, portfolio composition, sectoral concentrations, geographic exposures, and operating environment. While broad macroeconomic scenarios were generally applied, institutions did not always demonstrate that stress testing scenarios adequately captured the risks most relevant to their specific risk profile. For example, institutions with material concentrations in particular sectors, geographic regions, customer segments, or counterparties did not consistently demonstrate the use of targeted scenarios designed to assess the resilience of those exposures under severe but plausible adverse conditions. Similarly, institution-specific operational, cyber, shareholder, funding, or market-related vulnerabilities were not always reflected within scenario narratives and underlying assumptions.

The MFSA also observed varying levels of maturity in the incorporation of both the normative and economic perspectives within stress testing frameworks. While most institutions demonstrated the use of stress testing for assessing regulatory capital adequacy under adverse conditions, the economic perspective was not always clearly articulated or sufficiently reflected within stress testing methodologies and supporting documentation. This indicates that, in some instances, stress testing remains primarily focused on regulatory capital outcomes rather than providing a comprehensive assessment of resilience from both a normative and economic perspective.

The assessment identified varying approaches in relation to scenario severity and calibration. While institutions generally applied adverse scenarios, the justification supporting the chosen level of severity was not always sufficiently documented. In several instances, institutions were unable to demonstrate that scenario calibration appropriately reflected institution-specific vulnerabilities, risk concentrations, or emerging risks. Reliance on externally prescribed supervisory scenarios was also observed. While such scenarios provide a valuable benchmark, institutions should ensure that adverse scenarios are appropriately tailored to reflect their business model, risk profile, and key vulnerabilities.

Further opportunities for enhancement were identified in the translation of stress assumptions into risk parameters and financial impacts. While institutions generally applied quantitative methodologies to estimate the impact of stress events on key risk indicators and capital metrics, supporting documentation did not always clearly evidence how stressed risk factors were translated into internal risk parameters across all material risk categories. In addition, documentation supporting model risk considerations, expert judgement overlays, independent validation, and challenge processes was not always sufficiently developed.

Finally, the review identified varying practices regarding the periodic reassessment of stress testing scenarios and underlying assumptions. While institutions generally reported that scenarios were reviewed and updated periodically, documentation supporting the reassessment of scenario relevance,

changing risk conditions, and emerging vulnerabilities was not always sufficiently developed to demonstrate an ongoing and forward-looking scenario management process. In particular, the frequency of scenario review and recalibration was not always aligned with supervisory expectations, and periodic reassessments were often linked to annual ICAAP cycles rather than being conducted on a more frequent basis to reflect material changes in the institution's risk profile or operating environment.

The Authority acknowledges that the complexity of scenario design and calibration methodologies should reflect the principle of proportionality and be commensurate with the nature, scale, and complexity of an institution's activities. Nevertheless, proportionality should not result in weaknesses in scenario governance, calibration practices, documentation, or review processes. Institutions are expected to ensure that scenario design frameworks are supported by robust governance, credible and sufficiently severe assumptions, appropriate challenge, and regular reassessment, such that stress testing continues to provide a meaningful and forward-looking assessment of resilience under adverse conditions.

SUPERVISORY EXPECTATIONS

The MFSA expects institutions to:

i. Maintain a formal and documented scenario design framework
ii. Develop institution-specific scenarios reflecting material vulnerabilities
iii. Apply appropriately severe and well-justified stress assumptions
iv. Clearly document calibration methodologies and expert judgement overlays
v. Ensure effective challenge and review across relevant functions
vi. Reassess scenarios periodically to reflect evolving risk conditions

While the complexity of scenario design methodologies may vary in line with the principle of proportionality, institutions should be able to demonstrate that scenario selection, calibration, challenge, and review processes provide a credible and forward-looking assessment of resilience under adverse conditions.

2.4 Reverse Stress Testing

Reverse stress testing forms an important component of an effective ICAAP and stress testing framework. In accordance with MFSA Banking Rule BR/26[5], the EBA Guidelines on Institutions' Stress Testing (EBA/GL/2018/04, paragraphs 90-98)[7], and the ECB Guide to the ICAAP (Principles 3, 4 and 7)[9], institutions are expected to use reverse stress testing to identify scenarios that could threaten the viability of their business model, challenge capital planning assumptions, assess recovery preparedness, and support the identification of institution-specific vulnerabilities.

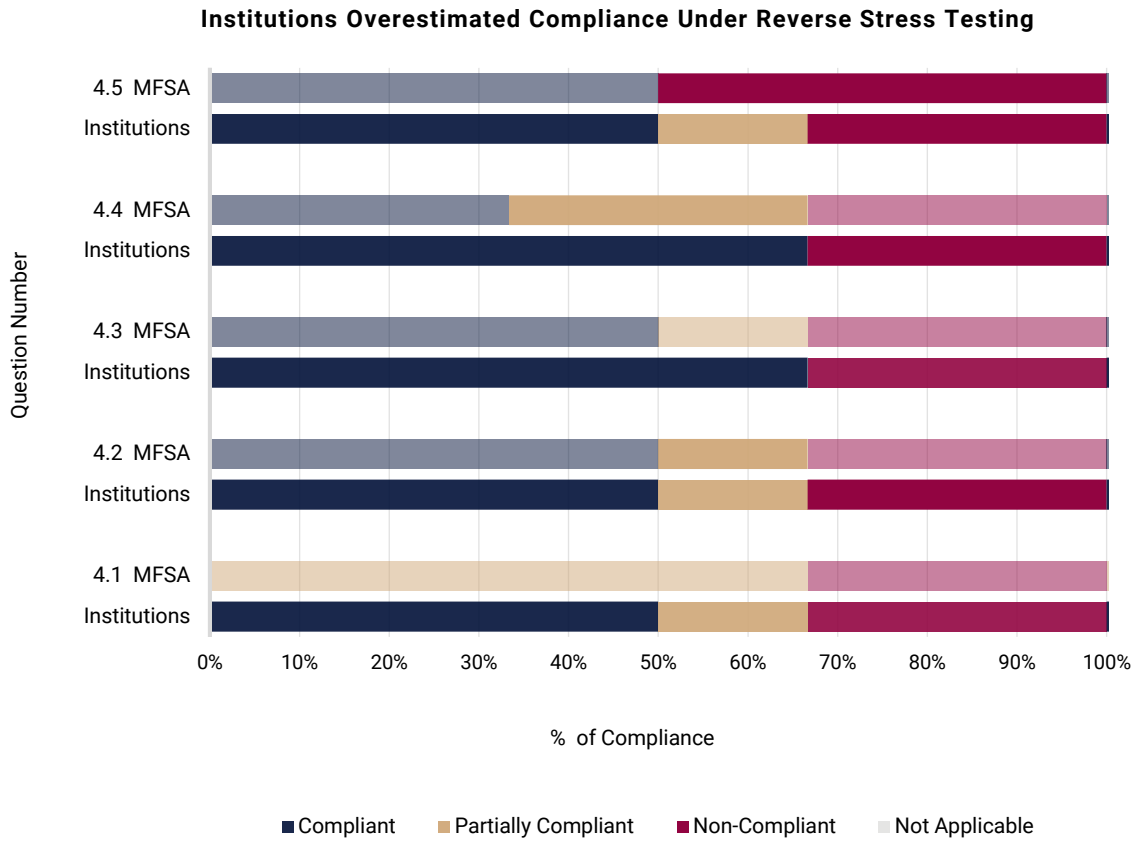

Figure 4: Reverse Stress Testing - Institutions' Self-Assessment versus MFSA Assessment

Note: The chart compares institutions' self-assessments with the MFSA's supervisory assessment. Solid colours represent institutions' self-assessment outcomes, whilst lighter shades of the same colour represent the MFSA's supervisory assessment. Across the areas reviewed, institutions generally reported higher proportions of '*compliant*' outcomes, while MFSA assessments shift classifications towards *'partially compliant'* and '*non-compliant*'.

Question References: (4.1) Reverse Stress Testing Governance and Framework; (4.2) Failure Scenarios and Narrative Design; (4.3) Use of Reverse Stress Testing in Capital Planning and Viability Assessment; (4.4) Integration with Recovery

Reverse stress testing represented one of the least mature components of institutions' stress testing frameworks and exhibited one of the largest divergences between institutions' self-assessments and the MFSA's supervisory assessment. Significant opportunities for enhancement were identified in relation to scenario design, viability assessment, capital planning, and integration with recovery planning processes.

Institutions generally reported that reverse stress testing formed part of their broader stress testing frameworks and that severe adverse conditions were considered as part of their ICAAP processes. However, the MFSA's assessment identified significant variations in the extent to which reverse stress testing was used as a meaningful tool to identify vulnerabilities, challenge assumptions, and inform

capital planning and risk management processes. The MFSA also identified instances where reverse stress testing was either not performed or conducted only to a limited extent, restricting institutions' ability to assess conditions that could threaten their viability or sustainability under severe stress.

While some institutions performed reverse stress testing exercises, these were not always sufficiently developed to support a meaningful assessment of vulnerabilities and viability under extreme conditions. In several instances, institutions were unable to demonstrate a structured approach for identifying failure points, assessing interactions between key risk drivers, or evaluating the implications of reverse stress testing outcomes for capital planning, risk management, and strategic decision-making.

The review further identified opportunities for enhancement regarding the identification of predefined failure outcomes and the development of reverse stress testing narratives. Institutions did not always demonstrate a structured approach for identifying scenarios that could render the institution's business model unviable, materially deplete capital resources, or threaten ongoing viability. In addition, institutions were not always able to demonstrate the specific capital, liquidity, operational, or other conditions that could lead to such outcomes. Reverse stress testing narratives were frequently insufficiently developed to explain the sequence of events, interactions between risk factors, and adverse conditions that could result in near-failure scenarios.

The MFSA also observed that reverse stress testing was not consistently used to challenge capital planning assumptions, assess institutional sustainability under extreme conditions, or inform the design and calibration of broader stress testing exercises. Evidence demonstrating how reverse stress testing outcomes influenced stress test severity, strategic decision-making, ICAAP assumptions, risk management practices, or capital planning discussions was often limited. In several cases, reverse stress testing appeared to be conducted as a standalone exercise rather than as an integral component of the institution's wider stress testing framework.

Areas for improvement were also identified regarding the integration of reverse stress testing with recovery planning frameworks. While some institutions demonstrated consideration of recovery planning elements, linkages between reverse stress testing outcomes, recovery triggers, recovery actions, and near-default scenarios were not always sufficiently established or evidenced. As a result, reverse stress testing did not consistently contribute to the calibration of recovery planning assumptions or to the assessment of the effectiveness, credibility, and timing of potential recovery measures.

Finally, the review identified varying levels of maturity in the use of sensitivity analyses as a foundation for reverse stress testing. While sensitivity analyses were generally performed, institutions did not always demonstrate how such analyses informed the development of reverse stress testing scenarios, the identification of breaking points, or the calibration of near-failure conditions. In a number of cases, sensitivity analyses and reverse stress testing operated as separate exercises rather than as complementary tools used to assess institutional vulnerabilities and resilience.

Institutions are expected to perform reverse stress testing on a regular basis and demonstrate how the results are used to identify vulnerabilities, challenge assumptions, assess threats to viability, and support risk management, capital planning, and recovery planning processes.

SUPERVISORY EXPECTATIONS

The MFSA expects institutions to:

i. Perform reverse stress testing on a regular basis

ii. Define credible failure and near-failure scenarios

iii. Develop robust reverse stress testing narratives

iv. Use reverse stress testing to challenge capital planning assumptions

v. Integrate reverse stress testing with recovery planning

vi. Use sensitivity analyses to support scenario design and calibration

Institutions should be able to demonstrate that reverse stress testing is used as a meaningful risk management tool to identify vulnerabilities, challenge key assumptions, assess potential threats to viability, and support capital planning and recovery preparedness.

2.5 Application of Stress Testing Outputs

Stress testing is expected to serve as a key risk management tool and should support informed decision-making across the institution. In accordance with MFSA Banking Rule BR/26[5], the EBA Guidelines on Institutions' Stress Testing (EBA/GL/2018/04, paragraphs 32–46)[7], and the ECB Guide to the ICAAP (Principles 2, 3 and 7)[9], institutions are expected to ensure that stress testing outputs are effectively integrated into risk management processes, capital planning, strategic decision-making, and the overall ICAAP framework.

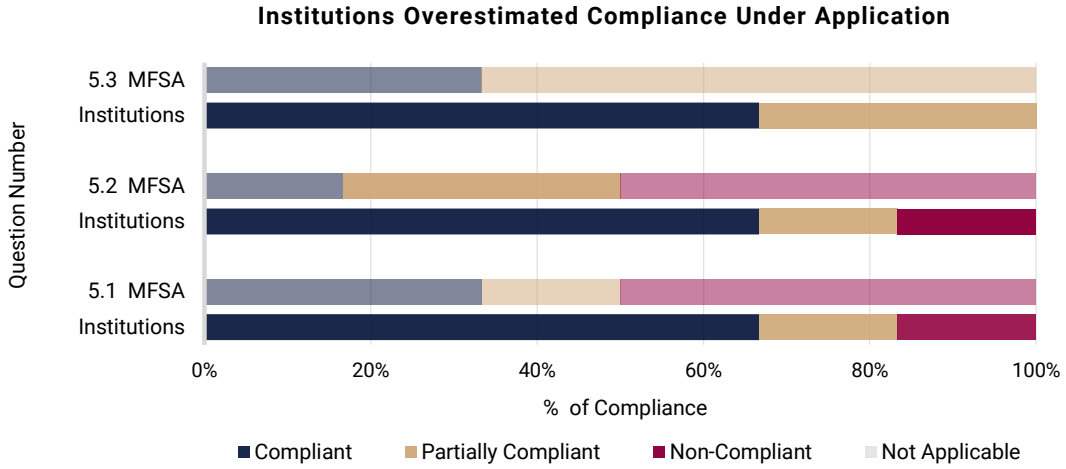

Figure 5: Application of Stress Testing Outputs - Institutions' Self-Assessment versus MFSA Assessment

Note: The chart compares institutions' self-assessments with the MFSA's supervisory assessment. Solid colours represent institutions' self-assessment outcomes, whilst lighter shades of the same colour represent the MFSA's supervisory assessment. Across the areas reviewed, institutions generally reported higher proportions of '*compliant*' outcomes, while MFSA assessments shift classifications towards *'partially compliant*' and '*non-compliant*'.

Question References: (5.1) Management Actions and Feasibility Assessment; 5.2) Communication, Governance, Risk

The assessment indicates that institutions generally considered stress testing outputs to be appropriately incorporated within their ICAAP processes and broader risk management frameworks. Institutions reported that stress testing results were communicated to senior management and at Board and Committee level, used to support capital planning activities, and considered when assessing resilience under adverse conditions.

However, the MFSA's assessment identified several areas where the practical application of stress testing outputs could be further strengthened. While institutions generally identified management actions within stressed scenarios, supporting documentation did not always demonstrate a sufficiently robust assessment of their feasibility, timing, effectiveness, or potential constraints under stressed conditions. In instances, management actions appeared to be presented as theoretical mitigating measures without adequate evidence demonstrating their credibility or practicality during periods of severe stress.

The review further identified opportunities for enhancement regarding the communication and use of stress testing results within decision-making processes. Although stress testing outputs were generally reported to relevant management, institutions did not always demonstrate how those results informed risk management decisions, strategic planning, business planning, or the review of risk appetite. Evidence demonstrating active consideration of stress testing outcomes by the Board of Directors and senior management was often limited.

The MFSA also observed varying levels of maturity in the integration of stress testing outputs into capital planning processes. While institutions generally assessed the impact of adverse scenarios on capital adequacy and regulatory capital positions, the link between stress testing outcomes, capital planning assumptions, contingency measures, and management responses was not always clearly articulated. In several instances, institutions were unable to demonstrate how stress testing results were used to challenge capital plans, assess ongoing solvency under adverse conditions, or support timely corrective action where vulnerabilities were identified.

Furthermore, opportunities for enhancement were identified regarding the interaction between stress testing outputs and other key risk management tools, including the risk appetite framework, recovery planning, and strategic planning processes. As a result, stress testing did not consistently operate as a central input into decision-making and forward-looking risk management activities.

The MFSA expects institutions to demonstrate that stress testing outputs are actively considered and used to support decision-making processes across the organisation. Stress testing should not be viewed solely as an annual ICAAP requirement; rather, it should serve as a practical tool for informing management actions, challenging assumptions, assessing resilience, supporting capital planning, and identifying the need for timely remedial measures.

SUPERVISORY EXPECTATIONS

The MFSA expects institutions to:

i. Assess the feasibility and effectiveness of management actions under stress

ii. Communicate stress testing results across relevant governance levels

iii. Use stress testing outcomes to inform risk appetite and strategic decisions

iv. Integrate stress testing outputs into capital planning processes

v. Implement timely remedial measures where vulnerabilities are identified

vi. Embed stress testing within broader risk management and decision-making frameworks

Institutions should be able to demonstrate how stress testing outputs influence management actions, risk appetite, capital planning, strategic decision-making, and the assessment of resilience under adverse conditions.

3.0 CLOSING REMARKS

The MFSA emphasises the importance of a robust ICAAP and stress testing framework as a cornerstone of prudent risk management and forward-looking capital planning. Effective stress testing enables institutions to identify vulnerabilities, assess resilience under adverse conditions, and take timely actions to safeguard their ongoing viability and financial soundness. When appropriately designed, governed, and applied, stress testing supports informed decision-making and enhances institutions' ability to withstand severe but plausible shocks.

The findings of this review indicate that, while institutions have established foundational ICAAP and stress testing frameworks, a recurring divergence remains between institutions' self-assessments and the MFSA's supervisory assessment. Across the areas reviewed, institutions generally demonstrated greater levels of maturity in relation to governance arrangements and the identification of key risk categories. However, recurring opportunities for enhancement were identified in relation to the comprehensiveness of stress test coverage, scenario design and calibration practices, reverse stress testing, and the practical application of stress testing outputs within risk management, capital planning, and strategic decision-making processes.

Across all areas reviewed, the MFSA observed that institutions generally assessed themselves as being more compliant than indicated by the Authority's supervisory assessment. This recurring divergence highlights the importance of applying a more critical and evidence-based approach when assessing the effectiveness, maturity, and practical application of ICAAP and stress testing frameworks.

The review also highlighted that stress testing continues, in some instances, to be viewed primarily as a regulatory compliance exercise rather than as an integral component of the institution's broader risk management framework. In particular, the MFSA observed that stress testing outputs were not always sufficiently leveraged to challenge assumptions, inform management actions, assess resilience, or support forward-looking business and capital planning decisions.

The MFSA expects credit institutions to carefully consider the findings outlined in this letter and, where relevant, take timely and appropriate action to address identified gaps and strengthen their ICAAP and stress testing frameworks. Particular attention should be given to ensuring that stress testing is appropriately embedded within governance arrangements, capital planning processes, recovery preparedness, and strategic decision-making, and that stress testing outcomes are demonstrably used to challenge assumptions and support forward-looking resilience assessments.

As part of its Compliance Outcomes-Based Supervision approach, the MFSA will continue to monitor institutions' progress in addressing the findings identified through this review. This thematic exercise is conducted on a three-year cycle, with the next review scheduled for 2027 and expected to cover the same sample of LSIs. This follow-up assessment will place particular emphasis on the extent to which institutions have effectively remediated identified weaknesses and embedded sustainable improvements within their ICAAP and stress testing frameworks.

Ultimately, the MFSA expects stress testing to evolve from a periodic regulatory exercise into a meaningful risk management tool that informs decision-making, strengthens capital planning, challenges strategic assumptions, and supports the long-term resilience of institutions operating within the Maltese banking sector.

Yours sincerely,
Malta Financial Services Authority

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