MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

13 November 2026

Circular on Regulatory Own Funds, Capital Adequacy and Prudential Expectations Applicable to Fund Managers and Investment Firms

1.0 Introduction

The Malta Financial Services Authority ("MFSA" or “Authority”) is issuing this Circular to remind licence holders of their obligations in relation to the maintenance of regulatory capital requirements under the European legislative frameworks governing Alternative Investment Fund Managers ("AIFMs"), UCITS Management Companies and MIFID firms.

Licence holders are required to maintain own funds that are equal to or in excess of their applicable capital resources requirement at all times. Adequate own funds are fundamental in ensuring that firms maintain sufficient financial resources to support their operations and meet their regulatory obligations on an ongoing basis. Such resources provide a financial buffer against losses, adverse business conditions, unexpected expenses, and other operational or financial shocks that may arise during business.

The scope of this Circular is to re-iterate the Authority's expectations regarding the quality, eligibility and ongoing assessment of regulatory capital.

2.0 Supervisory Observations

Through ongoing supervisory engagement, the Authority has identified instances where licence holders may not have sufficiently assessed the quality, availability and eligibility of assets supporting their regulatory own funds requirement. In certain cases, excessive reliance may have been placed on accounting capital measures without adequate consideration of the prudential requirements governing regulatory own funds.

A fundamental principle of prudential regulation is that capital adequacy depends not only on the quantity of capital held but also on its quality. A capital instrument's quality is determined by its ability to absorb losses when the firm experiences financial stress, and therefore, the ability to convert the instrument into liquid capital in a timely manner in times of stress.

Prudential Objective of Regulatory Capital – Investment Firms

The prudential regime established under Regulation (EU) 2019/2033 ("IFR") and Directive (EU) 2019/2034 ("IFD") seeks to ensure that investment firms maintain adequate financial resources commensurate with the risks arising from their activities and the potential harm that may be caused to clients and markets.

It is important to recognise that regulatory capital is not intended to guarantee that an investment firm will never fail. The prudential framework should therefore be viewed as a mechanism for promoting financial resilience and safeguarding market integrity.

The Authority has observed that certain investment firms may place undue reliance on accounting equity when assessing their capital position. While accounting capital is relevant for financial reporting purposes, the prudential framework applicable to investment firms is based on the concept of regulatory own funds, which are designed to ensure that firms maintain capital resources that are capable of absorbing losses and supporting the firm's resilience under stressed conditions. Whilst accounting capital and regulatory own funds may overlap, the two concepts are not synonymous. It is the responsibility of the Board of Directors and control functions, in particular the compliance and risk management functions (as applicable) to monitor the magnitude and quality of own funds and to stress test such quality.

Composition and Quality of Own Funds in the Case of MIFID Investment Firms

The IFR framework emphasises the loss-absorbing capacity of own funds. Consequently, not all balance sheet resources qualify as regulatory own funds, notwithstanding their recognition for accounting purposes.

Investment firms subject to the IFD/ R are required to maintain own funds consisting of Common Equity Tier 1 ("CET1"), Additional Tier 1 ("AT1") and Tier 2 ("T2") capital[1]. Investment Firms are required to meet all of the following conditions at all times[2]:

(a) Common Equity Tier 1 capital

$$\frac{\text{Common Equity Tier 1 capital}}{D^{3}} \geq 56\%$$

(b) Common Equity Tier 1 capital + Additional Tier 1 capital

$$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 capital}}{D} \geq 75\%$$

(c) Common Equity Tier 1 capital + Additional Tier 1 capital + Tier 2 capital

$$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 capital + Tier 2 capital}}{D} \geq 100\%$$

The prudential framework does not merely prescribe a minimum amount of own funds but also establishes detailed eligibility criteria governing the recognition of capital instruments, in order to ensure that the quality of capital remains up to the required standards. From a prudential perspective, higher-quality capital generally exhibits characteristics such as permanence, availability, subordination to creditors and the ability to absorb losses on a going-concern basis.

Common Equity Tier 1[4] capital is regarded as the highest-quality form of regulatory capital because losses are recognised directly against shareholders' funds without the need for contractual trigger events or creditor intervention.

[1] Article 10 of the IFR sets the capital structure needed to cover the Total Own Funds Requirement.
[2] Part Two, Article 9 'Own Funds Composition', of Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019, on the prudential requirements of investment firms and amending Regulation (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014.
[3] Article 11(1) of Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019, on the prudential requirements of investment firms and amending Regulation (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 defines 'D' as the highest of the following:
(a) their fixed overheads requirement calculated in accordance with Article 13;
(b) their permanent minimum capital requirement in accordance with Article 14; or
(c) their K-factor requirement calculated in accordance with Article 15.
By way of derogation from paragraph 1, where an investment firm meets the conditions for qualifying as a small and non-interconnected investment firm set out in Article 12(1), D shall be defined as the highest of the amounts specified in points (a) and (b) of Article 11(1).
[4] Article 28 of the CRR requires that CET1 instruments to be ordinary equity, perpetual, fully loss-absorbing and subordinated. These characteristics are the legal basis for CET 1 being regarded as the highest-quality capital.

The IFD/IFR framework further recognises that not all assets recorded on a firm's balance sheet possess the same loss-absorbing capacity during periods of financial stress. While such assets may be recognised for accounting purposes, they may not necessarily be available to absorb losses on a timely basis or support the firm's continued viability in a stress scenario.

Accordingly, the prudential framework requires a number of regulatory adjustments and deductions to be applied when determining eligible own funds. These include, amongst others, deductions relating to intangible assets, deferred tax assets that rely on future profitability, direct and indirect holdings of own capital instruments, and certain holdings in financial sector entities. Such deductions are intended to ensure that regulatory own funds comprise resources that are genuinely capable of absorbing losses when needed. Licence holders should therefore not assume that the existence of accounting equity automatically translates into an equivalent amount of prudentially recognised own funds. Nor, should a Licence Holder invest its regulatory capital in instrument which have a low quality.

Risk Management & Internal Capital Adequacy Assessement Process

The Authority reminds investment firms that compliance with minimum own funds requirements under the IFR represents a regulatory floor and should not be regarded as the sole measure of capital adequacy.

Part BI of the Investment Services Rules for Investment Services Providers, specifically R3-3.1.1.1, requires licence holders to *"have in place, sound, effective and comprehensive arrangements, strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and liquid assets that they consider adequate to cover the nature and level of the risks which they may pose to others and to which investment firms are or might be exposed"*. Compliance with Pillar 1 own funds requirements is not necessarily sufficient in all circumstances.

The Authority expects firms to be capable of demonstrating, at any time, how the conclusions reached through their ICARA process support the level, composition and allocation of regulatory capital maintained by the firm.

Regulatory Capital Quality – AIFMs and UCITS Management Companies

Article 9 of Directive 2011/61/EU establishes the initial capital and own funds requirements applicable to of Alternative Investment Fund Managers ('AIFMs'). In particular, an internally managed AIF is required to maintain initial capital of at least EUR 300,000. This capital serves a prudential purpose and should not be regarded as part of the scheme's investment portfolio. Rather it should remain separately identifiable and continuously available to meet regulatory capital requirements and potential liabilities arising from the management of the fund. A comparable principle applies to the initial capital requirements applicable to self-managed UCITS investment companies[5].

Where an AIFM is appointed as the external manager of one or more AIFs, it is required to maintain initial capital of at least EUR 125,000. In addition, where the value of the portfolios managed exceeds EUR 250 million, the AIFM must hold an additional amount of own funds in accordance with Article 9(3) of Directive 2011/61/EU. The additional amount of own funds requirement reflects the increasing scale and complexity of the activities undertaken by the AIFM and serves to provide additional financial resources to absorb risks associated with its management activities. In this regard, the Directive also recognises professional liability risks and permits, subject to the applicable conditions, the use of professional indemnity insurance or a combination of additional own funds and professional indemnity insurance to address such risks.Similar capital requirements apply to UCITS management companies pursuant to Article 7 of Directive 2009/65/EC.

Article 9(8) of Directive 2011/61/EU on Alternative Investment Fund Managers ("AIFMD"), as transposed into SLC 6.16 of Part BIII of the Investment Services Rules for Investment Services Licence Holders which qualify as AIFMs ("the AIFMs Rules"), requires that own funds be *"invested in liquid assets or assets readily convertible into cash in the short term and must not include speculative positions"*. From reviews conducts, the Authority identified instances where regulatory capital has not satisfied this definition.

Accordingly, the Authority expects licence holders to conduct a comprehensive assessment of the components comprising their regulatory own funds to ensure continued compliance with the requirements set out in SLC 6.16 of the AIFM Rules. Licence holders should also ensure that appropriate controls and ongoing monitoring procedures are established to assess compliance with these requirements on a continuous basis. Such monitoring should form part of the firm's Compliance Monitoring Programme.

Particular attention should be given to circumstances where certain elements contributing to the firm's initial capital, as referred to in SLC 6.03 of the AIFMs Rules, may not satisfy the liquidity and convertibility requirements prescribed under SLC 6.16. Licence holders are

[5] ESMA_QA_2227, Submission Date 02/07/2024

therefore expected to assess whether all components recognised for regulatory capital purposes remain available, liquid, and readily convertible into cash within a short timeframe.

3.0 Conclusion

The Authority expects licence holders to maintain adequate records and supporting documentation demonstrating compliance with the above requirements, including evidence of the assessments, controls, and monitoring activities undertaken. In addition, Licence Holders shall assess the liquidity element of the instruments falling within the capital requirement and shall document the assessment accordingly.

Such documentation should be sufficiently detailed, accurate and up-to-date to enable the Authority to assess the rationale, robustness and effectiveness of the licence holder's capital adequacy assessments and related governance arrangements. Assertions that assessments have been performed, or that risks have been considered, may not be regarded as sufficient where these are not supported by appropriate documentation. It is the responsibility of the Board of Directors to ensure that the Licence Holder’s quality of regulatory capital meets the required standards and to consider additional capital buffers as deemed necessary.

Where licence holders identify deficiencies or circumstances that may adversely affect the eligibility, quality, or adequacy of their regulatory own funds, appropriate remedial action should be taken without undue delay.

Following issuance of this Circular, licence holders are expected to review their regulatory own funds composition and capital adequacy arrangements, taking into account the expectations outlined above.

The maintenance of adequate and high-quality own funds contributes to the financial soundness and resilience of licence holders and ultimately supports investor protection and confidence in Malta's financial services sector.

In conclusion, the Authority will be conducting further thematics on the quality of regulatory capital.

4.0 Contacts

Any queries on this Circular should be directed to the Funds Team (funds@mfsa.mt) and the Investment Firms Team (investmentfirms@mfsa.mt) within the Investment Services Supervision function of the MFSA.