

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular regarding the EU Capital Requirements Directive

21st August 2006

This Circular is being addressed to Investment Services Licence Holders subject to financial resources requirements in terms of the MFSA's Investment Services Guidelines

Background

The prudential regulation of investment services licence holders has been one of the MFSA's duties since the coming into force of the Investment Services Act, 1994. Before Malta's EU accession on 1st May 2004, certain revisions to the MFSA's financial resources requirements for investment services licence holders were effected with the purpose of aligning these requirements with the EU Capital Adequacy Directive (Council Directive 93/6/EEC of the 15th March, 1993 - "the CAD").

On the 14th June 2006, the Council of the European Union and the European Parliament adopted the Capital Requirements Directive ("the CRD"). Member States are required to transpose and implement the CRD by 1st January 2007.

The implementation of the CRD poses a considerable challenge and, as in the case of the EU Markets in Financial Instruments Directive (MIFID), it is the MFSA's intention to ensure that this is undertaken in a practical manner, taking into account the size of Malta's financial services operators. The main purpose of this circular is to ensure that investment services licence holders are aware of the upcoming implementation of the CRD and of MFSA's plans in this regard.

What is the CRD?

The CRD lays down capital adequacy requirements applying to investment firms and credit institutions, the rules for their calculation and the rules for their prudential supervision, enabling competent authorities to evaluate the adequacy of such entities' own funds, having regard to the risks to which they are exposed. It is a substantial redraft of two existing European Directives, the CAD and the Banking Consolidation Directive. The CRD is one of the measures required to complete the European Commission's Financial Services Action Plan, and is a major piece of legislation which modernises the existing capital framework to make it all-inclusive and risk-sensitive, encouraging enhanced risk management by investment firms and credit institutions.

The main change being introduced by the CRD is that it applies more comprehensive capital requirements than in the past. In particular, it introduces the concept of 'operational risk' which is an increasingly important risk for financial services institutions in general. With respect to investment firms, an impact analysis prepared by the European Commission suggests that the operational risk charge would significantly increase the applicable capital requirements. However, the CRD exempts certain 'low risk' investment firms (asset managers, receivers and transmitters of orders to trade, executors of orders to trade, placers of orders with no firm commitment and investment advisors) from the operational risk requirement. As we presently interpret the CRD Operational Risk provisions, the following investment firms are eligible for a waiver from the CRD's operational risk capital requirement:

- a) Category 1a, 1b, 2 and 4 investment service licence holders
- b) Category 3 licence holders which in practice engage in a limited range of activities as specified in the CRD.

The vast majority of Maltese investment firms currently fall within the category of low risk firms and should therefore be exempt from the CRD's operational risk capital requirement.

Way Forward

The MFSA is currently working on the required changes which will need to be effected to its Investment Services Guidelines to transpose the CRD. The Authority plans to issue the proposed revised requirements to investment services licence holders during the fourth quarter of this year, allowing for a minimum four week consultation period before the requirements are finalised and brought into force.

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