

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular regarding the EU Capital Requirements Directive ('CRD')

10th December, 2008

This circular is being addressed to Investment Services Licence Holders and their auditors

The MFSA invites comments by not later than the 12th January, 2009 on this consultation document. Interested parties are to send their comments in writing addressed to the Director – Securities Unit.

Background

The EU Capital Requirements Directive ['CRD'] is built upon three pillars. Pillar I of the CRD revised the minimum capital requirement which existed under the Capital Adequacy Directive. Pillar II requires investment firms to assess the amount of internal capital they consider adequate to cover all risks to which they might be exposed. Pillar III requires investment firms to develop a set of disclosure requirements which will allow market participants to assess the key information about the firm's underlying risks, models, controls and capital position.

As indicated in the MFSA's circular of the 20th August, 2008, the MFSA has not yet transposed the Pillar III requirements of the CRD for investment firms. This circular and accompanying annexes have the purpose of:

[a] outlining the manner in which the MFSA Securities Unit intends to transpose the CRD Pillar III requirements; and

[b] serving as a consultation document on the transposition of the CRD Pillar III requirements.

Transposition of the CRD Pillar III requirements

The MFSA - Securities Unit is planning to transpose the CRD Pillar III requirements through:

[a] changes to Part B of the Investment Services Rules for Investment Services Providers. Three new standard licence conditions will be included in a new sub-section of Section 7 of Part B of the Investment Services Rules for Investment Services Providers, to be titled '*Regulatory Disclosures by Licence Holders*'. These requirements will **not** apply to:

[i] credit institutions which are also Licence Holders – given that these will be subject to the requirements for credit institutions arising from the Banking Act, 1994;

[ii] Category 1 Licence Holders; and

[iii] Licence Holders which only provide management services to collective investment schemes.

[b] the introduction of a new Appendix 4. This appendix elaborates on the disclosures which Licence Holders and Investment Services Consolidation Groups are required to make in order to ensure compliance with the new standard licence conditions which transpose the CRD Pillar III requirements.

Changes to Part B of the Investment Services Rules for Investment Services Providers

Three new licence conditions will be added to Section 7 of Part B of the Investment Services Rules for Investment Services Providers. These new licence conditions, a copy of which is attached as annex I to this consultation document, have *inter alia* the purpose of requiring Licence Holders:

[a] to publicly disclose information on their own funds, their risk components, and their risk management and internal capital adequacy assessment process; and

[b] to adopt a formal policy to comply with the disclosure requirements laid down in these SLCs.

The new licence conditions also stipulate certain additional disclosure requirements for Investment Services Consolidation Groups.

Appendix 4 of Part B of the Investment Services Rules for Investment Services Providers

A copy of this draft Appendix 4 is attached as annex II to this consultation document. This Appendix stipulates the information which Licence Holders are required to make public and outlines the additional disclosure requirements for Licence Holders which form part of an Investment Services Consolidation Group.

Contacts

Should you have any queries regarding the above or the attached annexes, please do not hesitate to contact:

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INVESTMENT SERVICES RULES FOR INVESTMENT SERVICES PROVIDERS

PART B: STANDARD LICENCE CONDITIONS – SECTION 7

Regulatory Disclosure by Licence Holders

7.49 The Licence Holder shall publicly disclose information on its own funds, its risk components, and its risk management and internal capital adequacy assessment process. Such disclosure shall include all the information stipulated in Appendix 4.

The Licence Holder shall adopt a formal policy to comply with the disclosure requirements laid down in this SLC and apply policies and procedures for assessing the appropriateness of its disclosures, including their verification and frequency.

The information required in this SLC shall at least be disclosed on an annual basis in the Licence Holder's audited annual financial statements.

The Licence Holder shall assess the need to disclose the information required in this SLC, more frequently than annually, if this is required given the nature, scale and complexity of its business.

This SLC shall not apply to:

- a. Credit institutions which are also Licence Holders;
- b. Category 1 Licence Holders; and
- c. Licence Holders which only provide management services to collective investment schemes.

7.50 Licence Holders which form part of an Investment Services Consolidation Group shall, in addition to complying with the requirements of SLC 7.49, ensure that the Investment Services Consolidation Group discloses in its audited financial statements information on its set-up, any current or foreseen material, practical or legal impediments to the transfer of resources among members of the group, and any shortfall in the financial resources of Investment Services Consolidation Group. Such disclosure shall include all the information stipulated in Appendix 4.

7.51 SLCs 7.49 and 7.50 shall not apply to Licence Holders which determine that the disclosure of the information required in terms of the above-mentioned SLCs is not material or is proprietary or confidential. In the event of such a determination, the Licence Holder shall: **[i]** request its Compliance Officer to prepare a Compliance Report which indicates the reasons for non disclosure; and **[ii]** in its annual audited financial statements state the fact that the

information required in terms of SLC 7.49 or SLC 7.50 has not been disclosed and the reason for non disclosure.

For the purpose of this SLC the terms material, proprietary and confidential shall have the following meaning:

Material: shall mean a piece of information the omission of which could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions;

Proprietary: shall mean information, the publication of which would undermine the Licence Holder's or Investment Services Consolidation Group's competitive position; and

Confidential: shall mean information which is bound by the duty of confidentiality.

Appendix 4

Technical Criteria on the Disclosure Requirements for Investment Services Licence Holders

This Appendix lays down the disclosures which Licence Holders and Investment Services Consolidation Groups are required to make in order to ensure compliance with the requirements set in SLCs 7.49 and 7.50 of Part B of the Investment Services Rules for Investment Services Providers.

1.0 Disclosure requirements for Licence Holders

In terms of SLC 7.49 of Part B of the Investment Services Rules for Investment Services Providers, Licence Holders are required to make public the information on its: [i] own funds; [ii] risk components; and [iii] risk management and the internal capital adequacy assessment process.

1.1 Own Funds Disclosures

The Licence Holder shall disclose the following information regarding its Own Funds situation:

- (a) a general description of the main components of the Licence Holder's Own Funds; and
- (b) the total amount of: [i] Tier One Capital; [ii] Tier Two Capital; [iii] Tier Three Capital; and [iv] Total Own Funds.

1.2 Risk Components Disclosures

The Licence Holder shall explain the risk components to which it is exposed. Such explanation shall be made in the manner outline in the paragraphs below.

1.2.1 Credit/Counterparty Risk Components

The Licence Holder shall disclose the total amount of its Credit/Counterparty Risk Component.

The Licence Holder shall disclose the method it has adopted for the calculation of its credit/ counterparty risk component, that is, either the Standardised Approach, or the Foundation Internal Ratings Based Approach or the Advanced Internal Ratings Based Approach.

When the Licence Holder applies the Standardised Approach to the credit/ counterparty risk, the Licence Holder shall make a general statement on: [i] the types

of exposure classes to which it is exposed; **[ii]** the residual maturity breakdown of these exposures, and **[iii]** the geographic distribution of these exposures.

Licence Holders which calculate the credit/ counterparty risk component through either the Foundation Internal Ratings Based Approach or the Advanced Internal Ratings Based Approach shall include an explanation on how this method is being applied by the Licence Holder. Prior to preparing such explanation the Licence Holder shall contact the MFSA for guidance on the type of information which is to be included.

1.2.2 Trading Book Business - Risk Components

The Licence Holder shall disclose the total amount of the risk components which form part of its trading book business risk, these being: **[i]** position risk component, **[ii]** the settlement risk component; **[iii]** the counterparty risk component; and **[iv]** free deliveries. By way of a note the Licence Holder shall also disclose a breakdown of this total amount, risk component per risk component.

1.2.3 Commodities Instruments Risk Components

The Licence Holder shall disclose the total amount of its commodities instruments risk.

1.2.4 Large Exposures Risk Components

The Licence Holder shall disclose the total amount of its large exposures.

1.2.5 Foreign Exchange Risk Components

The Licence Holder shall disclose the total amount of its foreign exchange risk component. The Licence Holder shall also disclose the currencies to which it is exposed.

1.2.6 Operational Risk

The Licence Holder shall disclose the total amount of its operational risk component.

The Licence Holder shall disclose the method it has adopted for the calculation of its operational risk component, that is, either the Basic Indicator Approach, or Standardised Measurement Approach, or the Advanced Measurement Approach.

Licence Holders which calculate the operational risk component by using the Advanced Measurement Approach shall include an explanation on how this method is being applied by the Licence Holder. Prior to preparing such explanation the Licence Holder shall contact the MFSA for guidance on the type of information which is to be included.

1.3 Risk Management and the Internal Capital Adequacy Assessment Process Disclosures

The Licence Holder shall disclose a summary of its Risk Management and Internal Capital Adequacy Assessment Process. Such summary shall include a brief description of all the risks to which the Licence Holder is exposed and an explanation on the manner in which the Licence Holder is managing these risks.

2.0 Disclosure requirement for Investment Services Consolidation Groups

The Licence Holder shall ensure that the Investment Services Consolidation Group discloses the following information:

- i. the names of the company/companies which form part of an Investment Services Consolidation Group;
- ii. the names of any other companies which fall within the scope of the term “group” in the Companies Act, 1995, but **do not** form part of the Investment Services Consolidation Group;
- iii. any current or foreseen material, practical or legal impediment to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiary undertakings; and
- iv. the aggregate amount by which the actual financial resources are less than the required minimum financial resources in all subsidiary undertakings which have **not** been included within an Investment Services Consolidation Group by virtue of the exemption of paragraph 5 of Appendix 3 A to Part B of the Investment Services Rules for Investment Services Providers.