MFSA MALTA FINANCIAL SERVICES AUTHORITY

25th March 2025

Banking Supervision Office
Tel: (356) 2144 1155

Dear Chief Executive Officer,

Re: Feedback letter on the findings of the industry-wide survey on the banks' preparedness to the changes in the Capital Requirements Regulation

In June 2024, the Authority issued a Dear CEO letter describing the major changes brought about by the amendments to the Capital Requirements Regulation, more commonly referred to as 'CRR3'. The letter also launched an industry-wide survey to all licensed credit institutions with a view to assess their preparedness to such changes. Institutions were requested to submit their replies by August 2024. The self-assessment survey encompassed two different approaches, catering for both quantitative and qualitative aspects. The following two sections present the findings in an aggregate manner.

1. QUALITATIVE SECTION

1.0 Background

The deliverables requested in the qualitative part were designed to ensure that credit institutions familiarise themselves and have established the necessary frameworks and capabilities to meet the updated regulatory requirements. Through the survey replies the Authority assessed whether credit institutions are adequately prepared across critical dimensions, including governance frameworks, strategy, risk management, IT infrastructure, and training. Through this initiative, the Authority has sought to ensure that:

a) institutions have a clearer understanding of their compliance status concerning CRR3 requirements, and
b) any areas requiring further attention or improvement will be identified and addressed to achieve full compliance.

1.1 Analysis Outcome

Based on the results submitted, the analysis revealed a varied distribution of expected impacts across several areas. With respect to **governance**, the following share of credit institutions reported an expected impact from the respective CRR3 changes:

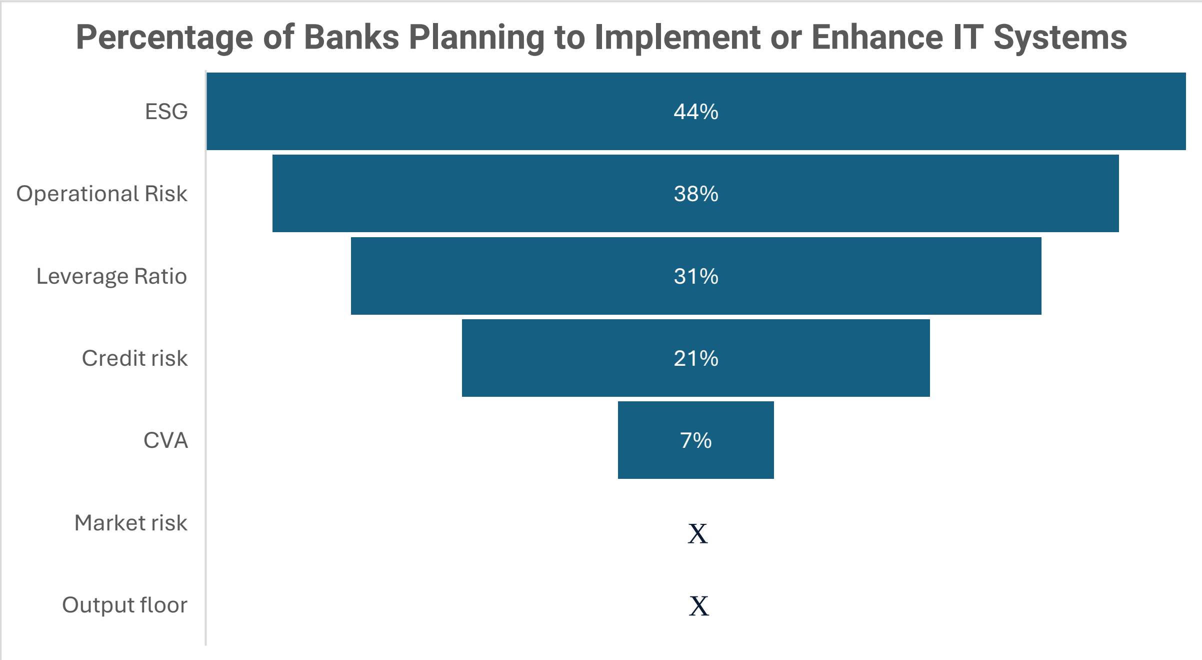
a) Environmental, Social and Governance (ESG): 81%;
b) Operational risk: 19%;
c) Market risk: 13%;
d) Credit risk: 9%;
e) Credit Valuation Adjustment (CVA): 8%; and
f) Leverage ratio: 6%.

No institutions reported any impact resulting from the introduction of the output floor.

In aggregate, credit institutions reported that they will incorporate CRR3 changes in their internal frameworks as follows:

a) For amendments related to **credit risk**, institutions plan to continue monitoring the underlying regulatory changes, attend dedicated training, and engage external advisors. To address these changes, significant updates are being made to the relevant policies, ICAAP frameworks, and Risk Appetite Statements.
b) With respect to the new **operational risk framework**, institutions are incorporating the emanating changes into their ICAAP and ILAAP frameworks, Risk Appetite Statements, related policies and procedures.
c) For **ESG amendments**, institutions plan to integrate the underlying requirements into their ICAAP and ILAAP frameworks, and related policies, including Pillar 3 disclosures.
d) In relation to **market risk** enhancements, institutions are focusing on revising policies and procedures.
e) Concerning changes to the **CVA and Leverage Ratio**, institutions declare that these changes are expected to be incorporated into policies, ICAAP frameworks, and they also plan to update their Risk Appetite Statements.

With a view to support CRR3 updates, institutions reported that they are planning on implementing and enhancing their **IT systems** to the extent depicted in the following chart. For changes related to market risk and the output floor, no IT enhancements/changes are being envisaged by institutions.



Source: Authority's calculations based on submitted survey results

Institutions enhanced their level of preparedness by following **specialised training** sessions across the major risk areas with participation from Finance, Risk, and Credit Departments. Specifically, it has been observed that over 73% of banks prioritised training on ESG and operational risk. Additionally, 27% of banks attended training on leverage risk, and training on credit risk was engaged by 23% of institutions.

1.2 Self-Assessment of Impact by Credit Institutions

Institutions were asked to assess the overall impact of CRR3 changes on their operations, with results varying across banks. Changes in relation to **credit risk, the new operational risk framework,** and **ESG requirements** were deemed as those having a direct effect, with some entities reporting high to medium impacts. The areas of **market risk, CVA,** and **leverage ratio** had an overall low to predominately no impact. All institutions reported 'no impact' from the introduction of the output floor provisions.

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2. QUANTITATIVE PART

2.0 Background

The quantitative sections of the self-assessment template focused on the changes of the underlying positions and exposures between the previous regulatory regime and the one applicable under CRR3. This part of the survey is made up of different sections and required the provision of more granular data, in relation to the **general capital levels, credit risk, operational risk, market risk, leverage ratio** and **securitisation**.

2.1 Analysis Outcome of the General Capital levels (Requirements) Section

From the data submitted, an overall average positive change of 1% in the **Capital Adequacy Ratio ("CAR")** and in the **Common Equity Tier 1 ("CET1") Ratio** was noted. Under the CRR3 regime and in absolute terms, changes pertaining to the credit risk framework resulted in an average increase of 5% in risk weighted assets. Moreover, the changes related to market risk caused on average an increase of 4% in the own funds requirement. On the other hand, the new methodology for calculating operational risk decreased such requirement by over 20%.

In terms of **credit risk**, such increases are partially attributable to a new asset class referred as *Asset, Development and Construction* which obliges institutions to apply risk weights of either 100% or 150%. Other changes were observed in the calculation of risk weights for capital requirements related to other exposures under *Income Producing Real Estate*, both for residential and commercial purposes. Furthermore, changes related to equity and retail exposures (mainly from personal loans and credit cards) also contributed to some degree.

The new regime for **operational risk** changes the way institutions calculate the own funds requirement for this risk element. Institutions on average reported a reduction of 23% in the related own funds requirement. Consistent with the qualitative part, the majority of banks highlighted the need to update their systems and policies to incorporate these changes and be prepared for the new reporting templates.

In relation to **market risk**, almost all the banks reported no changes in their quantification. A very low number of institutions reported an impact in relation to the introduction of the 1.2 multiplier for FX and gold exposures. Within this context, a dedicated Delegated Regulation has been issued, delaying by a year the related changes for calculating the own funds requirements for this risk area. Similarly on

leverage ratio, almost all the banks provided *nil* changes. Finally, for those institutions that reported **securitization** positions, no changes have been noticed.

3. THE AUTHORITHY'S ASSESSMENT

Based on the Authority's own evaluation of the responses, each institution was assigned to one of the four distinct categories mentioned below:

a) **Highly Prepared Institutions:** These institutions have implemented comprehensive measures and controls, demonstrating a thorough understanding of regulatory requirements and a robust compliance framework;
b) **Reasonably Prepared Institutions:** Substantial progress has been made, and these institutions are in good standing to comply with regulatory changes;
c) **Partially Prepared Institutions:** Initial steps have been taken, with basic measures and processes in place. However, certain areas require further improvement or refinement; and
d) **Not Prepared Institutions:** These institutions lack sufficient measures or processes. Significant gaps exist in their understanding, implementation, or documentation of CRR3 requirements.

Such assessment revealed that a number of institutions are sufficiently prepared for the upcoming regulatory changes and hence could be assigned to the higher categories [*in the "a" and "b" categories above*], whilst a number of others, have been deemed to require more effort. Across the spectrum, four institutions fall in the highly prepared category, whilst two have been deemed as not prepared. Notwithstanding, considering the aggregate asset size of all licensed credit institutions as at end 2023, the majority of the local banking sector assets belong to institutions deemed as sufficiently prepared.

4. CLOSING REMARKS AND WAY FORWARD

The survey findings suggest a varied understanding of the regulatory changes by institutions and the respective impact brought about by CRR3. The Authority deems that such outcome requires further commitment and focus from those entities that have been deemed partially and not prepared.

It is acknowledged that the ESG area in general will have a considerable affect, and for most institutions, a more defined and structured approach for managing these risks is called for. The Authority is communicating with the banks on the identification and management of Climate and Environmental Risk under separate cover from this letter.

Together with ESG, amendments related to operational and credit risk are those areas that have been deemed to have the greatest degree of impact on institutions. The Authority encourages institutions to invest more on specialised and diverse training covering different aspects of these areas. Local institutions at the current juncture do not make use of internal models to calculate their capital needs, thus and as opposed to other jurisdictions, there is no effect from the introduction of provisions related to the Output Floor.

From a purely qualitative perspective and based on reported figures, institutions' capital levels seem well placed to absorb the underlying changes which CRR3 will bring. In terms of the regulatory reporting and disclosures, the Authority continues to underscore the importance of being adequately prepared for the incoming changes. Moreover, it is essential that institutions continue to monitor developments, especially any emanating technical standards and EBA Guidelines that are issued on the basis and as a result of the revised CRR/CRD legislation.

The Authority is discussing a number of institution-specific findings within the supervisory engagement process that is carried out on a regular basis with the various banks. This proactive approach is aimed at fostering resilience and ensures that the landscape continues to evolve prudently, with local banks expected to keep working on their compliance with these new regulatory requirements.

Yours Sincerely,
Malta Financial Services Authority

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