MFSA

MALTA FINANCIAL SERVICES AUTHORITY

THE FRAMEWORK OF SUPERVISION FOR CREDIT INSTITUTIONS

BANKING SUPERVISION UNIT

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1. INTRODUCTION

The objective of the Framework of Supervision for Credit Institutions is to provide a detailed description of the risk-based approach for the supervision of credit institutions authorised under the Banking Act 1994 as applied by the Banking Supervision Unit within the Malta Financial Services Authority (MFSA).

The Framework aims at increasing the understanding of how the Banking Supervision Unit conducts its supervisory role in order to safeguard the safety and soundness of the Maltese banking system. Through this process, problem institutions can be identified and remedial action undertaken to protect depositors' money. Nonetheless, it should be emphasised that the responsibility of each credit institution is to conduct business in a safe and prudent manner and in accordance with legal requirements, rests with the directors and senior management of the institutions themselves.

The Banking Supervision Unit is committed to assess the business of credit institutions in terms of the risks faced by the institutions themselves and those that could arise from general instability in the financial market, primarily to protect depositors. It aims to introduce and implement supervisory measures and to make use of effective supervisory and risk management tools in order to achieve its objectives.

The risk-based approach set out in this document is consistent with international standards of supervision. The approach is intended to take into consideration capital, the nature of the business activities, internal controls and quality of management of licence holders.

This Framework is intended to foster further understanding between the Banking Supervision Unit and licence holders to improve the latter's understanding of the supervisory tools and methodologies applied.

On its part, the Unit endeavours to familiarise itself with the different business profiles of licence holders as well as the quality of their management. At the same time, licence holders should be able to benefit from the risk-based focus of supervisory inspections since the proper identification of risks and the implementation of adequate and effective control is in the mutual interests of both supervisors and supervised parties.

2. REGULATED ENTITIES

The entities regulated by the Banking Supervision Unit in terms of the Banking Act 1994 include branches of non-EEA countries. In terms of the Banking Act 1994, the business of credit institutions include the taking of deposits from the general public.

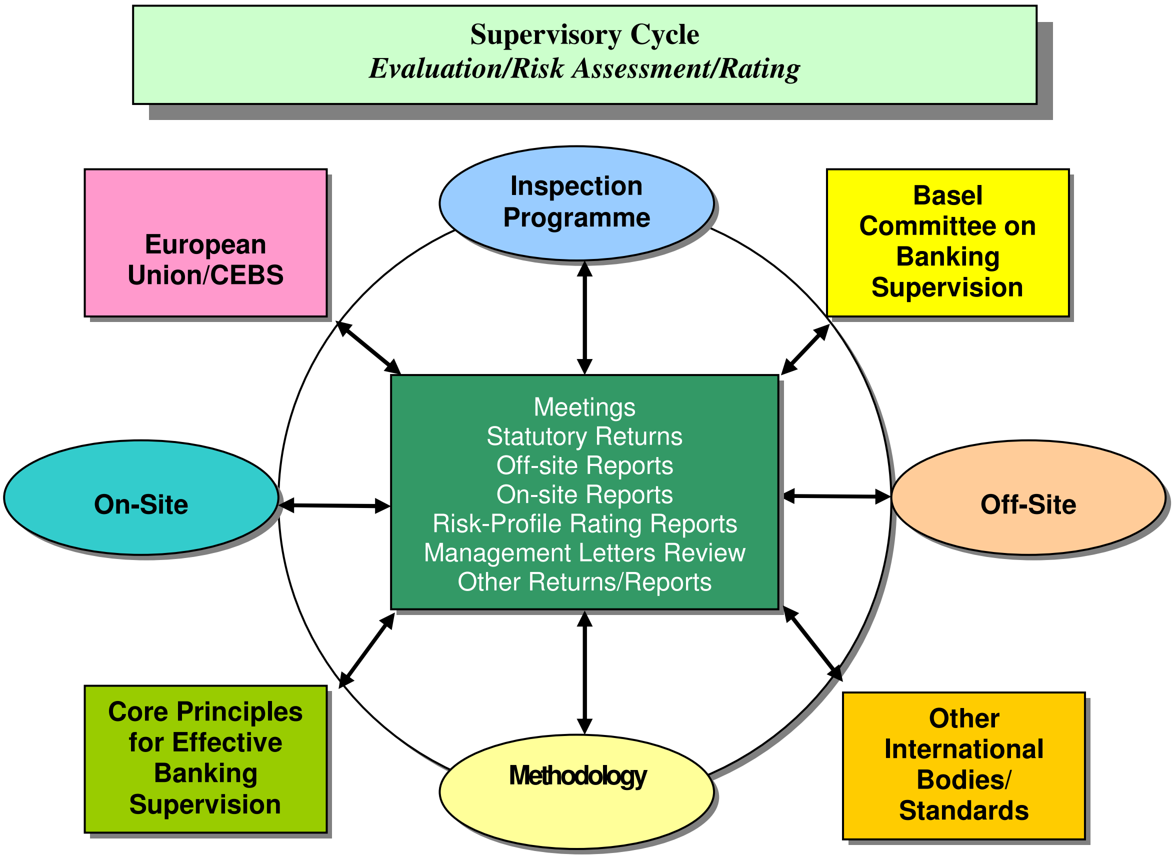
3. THE BANKING SUPERVISION UNIT

The Banking Act 1994 is the main piece of legislation that provides the framework of responsibilities and objectives of the Banking Supervision Unit. This Act is reinforced by Banking Rules and Electronic Money Directives and Legal Notices, together with a number of Policy Papers that are issued from time to time in order to strengthen the supervision process. Except for Legal Notices which are issued by the Minister of Finance, these documents are published following approval by the Supervisory Council of the MFSA. The Supervisory Council was established subsequent to the enactment and in terms of the relevant provisions of the Malta Financial Services Authority Act 2002. The Council comprises the Director Authorisations Unit, Director Banking Supervision Unit, Director Insurance and Pensions Supervision Unit, Director Securities and Markets Supervision Unit and the Director Regulatory Development Unit. It is chaired by the Director General. In order to carry out its regulatory and supervisory duties, the Banking Supervision Unit comprises two mutually dependent sections namely:

A) **Off-site Supervision and Methodology** which is primarily responsible for the off-site supervision of licence holders through the analysis of statutory financial information periodically submitted by such licence holders in terms of their legal obligations. The Section also participates in a number of technical Working Groups/Committees. The "methodology aspect" includes the drawing up of risk rating reports on selected licence holders using a variety of sources to establish an overall risk profile.

B) **On-site Supervision** which is primarily responsible for examinations at the business premises of licence holders.

The diagram below illustrates the whole supervisory cycle.



3.1.0 OBJECTIVES

Within the structure of the MFSA, the Banking Supervision Unit's objective is to achieve a high level of professionalism, integrity, credibility, and impartiality at all times. Ethical behaviour and accessibility are on the Unit's daily agenda. Through this process, the Unit has continued to build upon the relationship of mutual trust with all key players in the financial sector following the transfer of the banking supervisory function from the Central Bank. This is regarded as an essential corollary to the Unit's objectives and is nurtured through regular open communication with all parties concerned.

The Banking Supervision Unit promotes and monitors the integrity, soundness, efficiency and stability of the licence holders it regulates and supervises. This is made possible through the effective application of internationally accepted regulatory and supervisory standards. It does so by:

- Issuing Rules in terms of the Banking Act 1994 Notices on matters relevant to the conduct and management of credit institutions and Policy Papers on the various business activities that characterise the market, following approval by the Supervisory Council.

- Ensuring that Rules and Notices are always updated in line with recognised international standards.

- Reviewing all information submitted in terms of the various Rules in order to monitor compliance thereto and to assess major banking risks on a continuous basis.

- Verifying that banks maintain sufficient assets to cover their liabilities, reviewing the manner in which these assets are valued and liabilities determined and assisting in defining and implementing consistent and appropriate policies concerning the valuation of assets and determination of liabilities.

- Carrying out regular inspections at credit institutions to ensure that the above objectives are being attained and that business is not being conducted in a manner detrimental to the interest of depositors and creditors, the financial system, and/or against the provisions of the Banking Act 1994, or any other relevant legislation as appropriate.

- Undertaking other *ad hoc* off-site and on-site supervisory exercises from time to time as may be necessary.

- Liaising with the Financial Stability Division as well as other Divisions within the Central Bank on matters of mutual interest and/or concern.

4. ANNUAL INSPECTION PROGRAMME

In consultation with the Director in charge of the Banking Supervisions Unit, the On-Site Section prepares an annual inspection programme prior to the beginning of each year. This programme is then discussed with and approved by the Director General.

The Inspectors adopt a risk-based approach to their on-site inspection programme. As such, specific inspections included in the programme will be based on the outcome of the analysis of risks as identified by the Off-Site and Methodology Section as well as the identification of further risks pursuant to previous on-site exercises. Apart from these specific reviews, a supervisory cycle of between 24 to 30 months will normally be followed when drawing up the Annual Inspection Programme. On the other hand, nothing precludes the Inspectors from carrying out an *ad-hoc* inspection at a licensed institution at any point in time if the need arises.

Given the risk-based approach to banking supervision, the greatest attention is given to the specific risks to which each credit institution is mostly exposed. Once the risks have been identified and classified in order of importance, the requisite resources will be allocated to ensure that all the necessary control measures are in place to mitigate those risks.

The manner in which the MFSA's Inspectors carry out their on-site reviews will be increasingly governed by the Supervisory Review Process under Pillar II of the Capital Requirements Directive (CRD) [European Union Directive 2006/48/EC] and more specifically by the CEBS Guidelines on the Application of the Supervisory Review Process (GL-03). These have been transposed into a Banking Rule BR/12/2008 – The Supervisory Review Process of Credit Institutions authorized under the Banking Act.

During the year, on-site inspection teams are identified to carry out the programmed or *ad hoc* reviews and report on their findings (refer to Section 6.0.0).

Where applicable, licence holders are supervised on a consolidated basis in accordance with the relevant Banking Rule on the Supervision on a Consolidated Basis of Credit Institutions authorised under the Banking Act (BR/10/2007).

5. OFF-SITE ANALYSIS

As indicated in Section 3.0.0, prudential and statistical returns are submitted by all licensed institutions on a monthly and quarterly basis. The quarterly returns are more comprehensive since these include a detailed breakdown of assets and liabilities, off-balance sheet items, profit and loss returns as well as liquidity, own funds, capital adequacy and large exposures returns.

The schedules, which are also submitted in electronic format, are initially vetted for completeness. The electronic version is used to update pre-set comparative tables that are used to analyse data and identify any trends that may give rise for concern. The returns are also analysed for compliance with legal requirements.

Each licence holder is allocated to a specific off-site Inspector or analyst. After analysing statutory returns, the appointed official compiles a report on the institution. The assessment in the report addresses five evaluation factors:

- **C**apital
- **A**ssets and Liabilities

- **M**anagement
- **E**arnings
- **L**iquidity.

The CAMEL factors are described in more detail in Section 5.3.0.

5.1.0 MONTHLY/QUARTERLY REPORTS

The individual institutions' analyses are collated to produce the monthly and quarterly reports. These include an Executive Summary evaluating any regulatory and/or supervisory concerns and the steps that have been taken or need to be taken in order to address any identified weakness, both in individual credit institutions and/or the system as a whole.

The monthly/quarterly report also includes balance sheet summaries, a number of accounting ratios and statistical information presented both in tabular or chart form.

In analysing the returns submitted by licence holders, analysts are also expected to undertake a qualitative examination of the relevant factors.

An analysis of annual trends is also undertaken in respect of the financial year-end returns of licence holders. To reinforce this analysis, reference is also made to the review carried out by the Regulation and Compliance Section of published financial statements of the respective licence holders.

The conclusions drawn from the monthly/quarterly reports would include any concern that may arise or which may be perceived to arise if current trends persist. Such conclusions would normally give rise to ad hoc on-site inspections, consultation with the Central Bank's Financial Stability Office, or both.

5.2.0. PERIODICAL ANALYSIS

The monthly/quarterly off-site reports constitute an individual analysis of credit institutions with an overall consolidated review as applicable. In order to be able to obtain an oversight of systemic patterns or risks arising over a period of time, the off-site report or other separate reports, as may be necessary, could also include analyses of overall data on specific areas. Such areas normally include:

- asset and liability growth patterns
- trends in credit risk
- liquidity
- earnings
- interest-rate risk
- non-performing loans.

The monthly/quarterly report may be circulated within the Banking Supervision Unit for any further comments or action if it is deemed necessary. After being reviewed by the Director Banking Supervision, the report is forwarded to the Director General to update him with the latest available developments and for any action which the Director General may deem necessary.

5.3.0 CAMEL

The monthly/quarterly off-site reports on credit and financial institutions are compiled using the CAMEL factors as a guide to help the Inspectors evaluate the major risk areas of a licence holder. Such factors also help in assessing the soundness of a licence holder, the identification of any regulatory concerns and its observation of legal requirements. However, other factors may also be taken into consideration as deemed appropriate in particular circumstances.

5.3.1 Capital

An evaluation under this heading is carried out to determine whether the credit institution's capital position is adequate to support the level of current and anticipated business activities and associated risks. The main areas examined and reported upon include own funds, loan-loss reserves in relation to assets, and the capital adequacy ratios.

5.3.2 Assets/Liabilities

ASSETS - The quality of both on- and off- balance sheet assets is examined under this heading. This includes an examination of the composition, quality, concentration, and provisions in relation to:

(i) Securities Portfolio

(a) Banking Book

The main areas include:

- top quality investment securities
- domestic and foreign components
- assets held to maturity
- assets available for sale
- maturity split
- the extent of reliance on these assets
- transfer to and from the trading book
- trends.

(b) Trading Book

Consideration is given to:

- the extent of trading book exposures
- domestic and foreign components
- fair or market value of assets held for trading
- transfer to and from the banking book
- trends.

(ii) Advances Portfolio

The assessment covers:

- the size, maturity, currency, and sectoral diversification
- the range and types of products
- growth patterns and reliance on these assets
- collateral and concentration of types of security
- quality of lending

- adequacy of general and specific provisions in respect of impaired assets
- unauthorised excesses and restructured facilities
- past due balances and non-performing loans.

(iii) Large exposures in order to analyse and determine the concentration of risk.

(iv) Overall asset growth rate.

LIABILITIES - The Inspectors define and analyse the liability profile of the licence holder to determine the extent of the funding volatility, its diversification, types of borrowers, currency denomination, and trends.

Such analysis would therefore mainly be directed at the following:
- composition of liabilities
- funding structure
- concentration and volatility
- funding costs
- trends
- stability
- cost of deposit structure.

5.3.3 Management

The possibility to assess the quality of management of licence holders through the analysis of statutory financial information is limited. However, it is possible to assess the quality of management from:

- timeliness of submission of statutory information
- quality of reporting
- ability to answer queries
- level of understanding of risks
- correspondence
- meetings.

5.3.4 Earnings

An evaluation under this heading is made in order to determine the profitability and earnings profile of the regulated entity as well as the quality and reliability of the institution's earnings. This includes an evaluation and comments on the:
- overall level of profitability
- net income in relation to assets
- advances revenue in relation to total revenue
- investment income in relation to total revenue
- pattern and changes in interest and fee income
- changes in interest expenses
- volatility of earnings
- margins and spreads
- effect of non-performing loans on profits due to specific provisions and interest in suspense
- overheads and expenses

- salaries
- other items.

5.3.5 Liquidity

In assessing liquidity, the Inspectors examine the maturity ladder, liquidity ratio, quality of liquid assets and compliance with the relevant Banking Rules.

6. ON-SITE SUPERVISION

An important element of overall banking supervision is the evaluation, on an on-going basis, of the various risks to which a credit institution is exposed, the management of these risks and actions taken to mitigate them. This task is assigned to the On-Site Section which carries out periodical reviews of the activities and management of licence holders.

The identification of risks is a continuous process. As such, the outcome of off-site analysis of statutory and regulatory returns and risk rating reports are normally the main sources through which risks can be identified. As stated in Section 4.0.0, the Banking Supervision Unit prepares an annual inspection programme based primarily on the identified risks and consequently in accordance with the supervisory cycle.

6.1.0 THE ON-SITE INSPECTION PROCESS

The On-Site Inspection process (RACE) is based on the following framework:

i. **R**isk Identification - an initial study of information available to identify the licence holder's risk profile.
ii. **A**nalysis and Examination - an analysis of the risk profile, followed by an on-site examination of the relevant area of operations, including review of risks and their management.
iii. **C**ommunication and Reporting – discussion of identified risks with the licence holder's management and drawing up a report on the Inspectors' findings for submission to the institution examined.
iv. **E**ffectiveness - following up of recommendations and comments made on the findings to establish effectiveness of reported improvements through remedial action.

6.1.1 Risk Identification

As highlighted in the introduction to Section 6.0.0, the identification of risks is a continuous process. Therefore, other than from the off-site analysis of returns and risk rating reports referred to earlier, risks may also be identified from the following sources:

i. previous inspection reports
ii. internal studies/reports
iii. external auditors' management letters and replies thereto

iv. risk areas identified in documents issued by other supervisory or international bodies such as the Basle Committee on Banking Supervision, IMF, OECD
v. media reports or other information in the public domain
vi. other information obtained from the Central Bank.

Following the identification of risks to be reviewed, a team of Inspectors is appointed to analyse these risks and consequently undertake preparatory work to carry out the on-site examination. The composition of the team is determined by the nature and size of the inspection. However, as a minimum, an inspection team will consist of a team leader and another Inspector.

6.1.2 Analysis of Available Information

Before commencing an on-site inspection, the Inspectors need to obtain as much relevant pre-visit information as possible. The sources include:

i. off-site reports
ii. management letters
iii. previous reports
iv. any relevant internal checklist
v. questionnaire replies related to previous inspections
vi. background correspondence
vii. any papers issued by international bodies on the specific risk to be examined
viii. any reputable studies on the subject.

Following this pre-visit analysis, the Inspectors review any relevant internal control questionnaires (ICQs) and checklists in order to assess whether the issues identified in the pre-visit analysis are covered. At this stage, the inspectors will determine whether to make use of one of the ICQs at their disposal during their review, which will enable them to garner certain information which they can consequently verify through their on-site analysis.

ICQs and checklists are complementary to each other. Whilst the ICQ is normally submitted to the regulated entity at the start of an on-site inspection, the checklist is completed by the Inspectors themselves during the course of their exercise. The regulated entity’s official responses to the questionnaire are then compared to the checklist’s results. The ICQs and checklists, which are updated on an on-going basis, will also be usually modified prior to use to take into consideration the relative operations and circumstances of the institution which is to be reviewed.

Following the decision of whether or not to utilize an ICQ, the inspection team leader would list the major issues that need to be reviewed during the on-site inspection. These will be in addition to the issues specified in the checklist and consequently, the inspection team will be able to draw up a plan showing how the inspection will be carried out. Thereafter, a meeting will be held between the identified inspection team, the Director of the Unit and the Deputy Director in charge of the On-Site Section in order to discuss and approve the procedures as planned by the inspection team.

In those instances where the credit institution to be reviewed is also licensed by any other unit within the MFSA, it is customary to advise the Securities and Markets Supervision Unit, the Insurance and Pensions Supervision Unit, or any other regulatory unit as the case may be, in order to enquire on any supervisory issues about which the Banking Supervision Unit Inspectors should be aware.

6.1.3 On-Site Examination

Once the preparatory work is completed, an appointment for an initial meeting is fixed with the relevant senior management officials of the institution being inspected. During this meeting, the institution is informed of the objectives of the inspection and any other related specific requirements. An inspection commencement letter, signed by the Director or in his absence, by the Deputy Director On Site Section, and addressed to the Chairman, Managing Director or Chief Executive Officer as may be applicable, is also handed in during the meeting together with the ICQ if the inspection team has elected to submit a questionnaire to the licence holder.

The actual inspection normally commences with a review of relevant internal audit reports and an interview with the internal auditors to assess the level of reliance that could be placed on the internal audit function. Thereafter, the inspection is conducted through interviews, examination of specific documentation, and other relevant information either at Head Office or branches as appropriate.

The main areas that are normally covered during supervisory inspections include:

i. *Credit Portfolio and Asset Quality* – the focus will be on an assessment of the adequacy of internal control systems and the degree to which these internal controls are applied within the credit control function. Other related areas include assessment of the adequacy of information utilised to assess credit proposals, frequency of reviews, grading, non-performing loans, specific provisions, and the capabilities of the IT systems to produce management reports as may be required for the day-to-day management of the credit portfolio. The scope of such an examination would therefore ultimately be that of assessing the institution’s asset quality and its credit risk management.

ii. *Treasury Operations* - the focus will be on the level of risk management, internal control procedures and IT systems’ capabilities to produce the required management information reports.

iii. *Statutory, capital adequacy and other returns* - an analysis of the systems used to compile statutory returns including controls to ensure the correct reporting of data in returns submitted by the licence holders.

iv. *Other areas* - these include all other types of inspections and will include internal audit, risk-management, review of compliance with prevention of money laundering and finance of terrorism (PMLFT) legislation, representative offices, operational risk and compliance to statutory and licence conditions.

Note should be made that in relation to PMLFT inspections, the MFSA carries out inspections in its capacity as agent to the Financial Intelligence Analysis Unit (FIAU), which following the amendments to the Prevention of Money Laundering Act 1994, is the entity primarily responsible for PMLFT issues. In this regard, the Banking

Supervision Unit will advise the FIAU of its intended On-site Inspection programme for the year immediately this has been drawn up.

In this context, the MFSA may be instructed to carry out specific PMLFT related inspections at any of the licensed credit institutions as the FIAU may deem fit. In such cases, the MFSA Inspectors will draw up a Report which will be forwarded directly to the FIAU who will decide on the course of action to take. Alternatively, the MFSA Inspectors will carry out reviews in line with their annual Inspection Plan and will subsequently forward that section of the report which deals specifically with PMLFT issues to the FIAU for the latter to take any action as deemed necessary from their end. The entire report will, in such cases, be forwarded to the institution directly by the MFSA.

Other than inspections which target specific risk areas, the Banking Supervision Unit also conducts full reviews and compliance visits at certain credit institutions. *Full reviews* are normally carried out at those credit institutions (normally subsidiaries of foreign credit institutions) where the depth and nature of operations may be somewhat restricted and therefore allows for such treatment by the Banking Supervision Unit. In these cases, all major activities are examined during a particular exercise. On the other hand, *compliance visits* are carried out at branches of foreign credit institutions of third countries.

6.1.4 Communication and Reporting

After an on-site inspection is concluded, the Inspectors draw up a summary of findings. Prior to the final meeting with the licence holder, the Inspectors' findings are discussed internally with the Director Banking Supervision, whose role is to analytically query the conclusions reached as a result of the exercise. Findings are then discussed during a final meeting with the senior management of the institution under examination. Depending on the seriousness of the Inspectors' findings, the Banking Supervision Unit may request the presence of the internal auditor, the external auditor and at least one non-executive Director of the institution during the final meeting.

Subsequent to the final meeting, an inspection report is drawn up by the Inspectors, following consultation with senior officials within the Banking Supervision Unit. The final report is then forwarded to the Deputy Director (On-Site Section) who makes his recommendations to the Director Banking Supervision. The Director would forward a copy of the report to the Executive Chairman or Chief Executive Officer of the institution examined, accompanied by a letter explaining the highlights of the report and any required remedial action. The bank's Executive Chairman, Chief Executive Officer or managing Director has to ensure that all members of the Board of Directors of the regulated entity are to be provided with a copy of the report. Board members have to acknowledge receipt in writing to the MFSA Banking Supervision Unit, declaring that they have perused the report in their capacity as Directors of the institution.

The Director Banking would also forward a copy of the inspection report to the Director General and will continue to update him with developments accordingly. The

Director General is empowered to inform and/or update the Supervisory Council if and as he deems necessary.

6.1.5 Feedback and Follow-up

The institution is expected to revert with its reaction to the report or to comments raised by the Inspectors within a stipulated time-frame as determined by the Inspectors themselves. On the basis of the action plan provided by the Inspectors as a conclusion to their report, the licence holder's reply would be expected to include explanations in relation to remedial action that has been taken or that would be taken by the licence holder. The Inspectors would then follow up accordingly.

Boards of Directors are held accountable for the safe and sound operation of their institution. As such, proper corporate governance needs to be enforced and Boards should be regularly reminded of their responsibilities. As previously stated in Section 6.1.4 of this Framework, the Board of Directors of the regulated entity are required to sign a declaration that they have read the particular on-site inspection report drawn up by the Banking Supervision Unit. With the aim of further developing the communication channels with a regulated entity's Board of Directors, the Banking Supervision Unit will call in all Board members for a meeting, wherein the Inspectors would present and discuss significant issues identified during inspection reviews, both on-site and off-site, as well as other regulatory or compliance issues. Such meetings would preferably be held on an annual basis, but if no major concerns are identified, such meetings may be held once during the supervisory cycle of the regulated entity.

6.2.0 MANAGEMENT LETTERS

As part of the on-going liaison process and to enhance and strengthen the co-ordination between External Auditors and the MFSA, the External Auditors' annual letter to an institution's management is assessed and analysed by the Banking Supervision Unit. The Inspectors evaluate these letters both in the light of any on-going concern or weakness, as well as any new development. If the situation warrants, the Unit requests further explanations and recommends remedial action as may be necessary. This procedure is part of the follow-up process on the effectiveness of agreed remedial action following an on-site examination performed during the reporting period.

6.3.0 QUESTIONNAIRES

The Compendium of Documents issued by the Basel Committee on Banking Supervision of the Bank for International Settlements (BIS), EU Banking Directives, CEBS Guidelines and High-Level Principles and the corresponding Banking Rules are the main sources used by the Banking Supervision Unit as a basis for the compilation of specific questionnaires on various supervisory issues. These questionnaires, addressed to the industry as a whole, normally focus on topical and general issues which may be of relevance and on which, more information is required in order to obtain a deeper understanding of a licence holder's activities. The objectives of a questionnaire can be various but would mainly serve to:

- Obtain an indication of the level of adherence to, or understanding of, particular regulatory/supervisory issues. This may be necessary if the Unit has an indication that there is an area of concern arising from this area of operation.
- Create awareness on a particular topic which is of interest to the whole sector.
- Obtain a general indication of the industry's opinion or view on a particular topic.

Replies to these questionnaires are analysed both individually and on a collective basis in order to assess the position of the licence holder on the issues reviewed. An internal report summarising these findings is normally drawn up in order to evaluate any risk and devise immediate supervisory action if necessary. If there is no need for immediate action, the analysis could serve as a basis for including an assessment of the identified risk in a future inspection, or the compilation of a specific checklist.

As already referred to in Section 6.1.2, a licence holder may be requested to reply to a questionnaire related to the specific subject of an on-site inspection, prior to the commencement of the exercise. The Banking Supervision Unit updates such questionnaires from time to time as may be necessary.

7. METHODOLOGY - CAMELS

The observations and concerns identified in the various on-site and off-site reports, as well as from other sources such as annual reports, management letters, correspondence with the credit institution and references relating to relevant articles derived from various sources including the media and international credit rating agencies' views are evaluated by this Section through a CAMELS analysis. After this assessment, the Banking Supervision Unit would be able to identify and understand better the whole risk profile of the supervised institution. The CAMELS analysis is used to allocate a component and composite rating to the credit institution. The conclusions drawn by this Section are normally used as a basis on which future on-site inspections are identified in order to allocate proper resources to the perceived areas of risk and also serve as a basis for communicating the relevant findings to the credit institution's Board of Directors.

The CAMELS system utilised to evaluate the risk-rating profile of licence holders specifies the various elements that need to be considered in order to arrive at a component rating. The procedure also allows for the compilation of a composite rating. In summary, the considerations to be given to the various CAMELS components are as follows:

(i) *Summary*

Each institution is assigned a composite rating based on the evaluation and ratings of six components of its financial condition and operations. Specifically, these factors address the adequacy of *capital*, the quality of *assets*, *management's* capabilities, the quality and level of *earnings*, *liquidity* and *sensitivity* to market risk (CAMELS). The evaluation of the components takes into consideration the size and sophistication of the institution, the nature and complexity of its operations, as well as its risk profile.

Both composite and component ratings are assigned on a 1 to 5 numerical scale. A rating of 1 indicates the highest rating with the strongest performance and risk management practices and hence with the least degree of supervisory concern. A rating of 5 indicates the lowest rating and weakest performance, inadequate or non-existent risk management practices and therefore gives rise to a maximum degree of supervisory concern.

The composite rating generally bears a close relationship to the assigned component ratings. *However, the composite rating is not necessarily an average of the ratings given to the components.*

Components are rated on the basis of a qualitative analysis of factors influencing that component as well as inter-relationships with other components. Depending on the situation of the credit institution, some components may be given more weight than others when assigning a composite rating. The assignment of a composite rating may incorporate factors that significantly influence the overall soundness and condition of the institution.

An important factor in evaluating an institution's overall risk is the ability of its management to recognise and address changing situations and address the risks associated from changing business conditions and new business activities. The management component is therefore given due consideration in the assignment of the composite rating.

Moreover, the ability of management to identify, measure, monitor, and control the risks of operations is also given special consideration in the evaluation of each component. Management practices vary considerably depending on the size, complexity and risk profile of the credit institution. Directors and senior managers in less complex licence holders are normally actively involved in the day-to-day management and operations of the credit institution. In these cases, relatively basic management systems may be adequate. More complex credit institutions require formal and detailed management systems and controls in order to direct and monitor day-to-day activities. However, although all credit institutions are expected to manage their risks properly, the less complex credit institutions would not require detailed or highly formalised management systems and controls in order to receive a strong or satisfactory component or composite rating.

(ii) *Capital Adequacy*

An institution should maintain capital in equilibrium with the nature and extent of the risks and the ability of its management to identify, measure, monitor, and control these risks. The weaker the management of these risks, the higher the capital required. Moreover, credit, market, and other risks should also influence the amount of capital required. The types and quantity of risks inherent in a credit institution's activities will also determine whether it is necessary to maintain capital above the required regulatory minimum in order to adequately reflect potentially adverse consequences that these risks pose to the credit institution's capital.

(iii) *Asset Quality*

The rating of asset quality reflects the quantity of existing and potential credit risk associated with the lending and investment portfolios, fixed and other assets, including off-balance sheet transactions. The ability of the credit institution's management to identify, measure and monitor credit risk is also considered. The assessment of asset quality should take into consideration the adequacy of general and specific provisions for loans and advances. Counterparty and issuer exposure and borrowers' default under actual and implied contractual agreements should be given due consideration. All other risks which impinge on the value or marketability of a credit institution's assets, including but not limited to, operating, market, reputation, strategic or compliance risk should be assessed.

(iv) *Management*

This rating, which to a certain extent, is rather subjective, reflects the capability of the Board of Directors and management to identify, measure, monitor, and control the risks in a credit institution's activities, ensuring its safe, sound and efficient operation in conformity with applicable laws and regulations. Directors must provide clear guidance as to what constitutes acceptable risk exposure levels, although they may not be actively involved in day-to-day activities. They must also ensure that appropriate policies, procedures, and practices are established. Senior management should translate the Board's objectives and risk limits into prudent operating standards. They are responsible for the development and implementation of policies, procedures and practices.

Depending on the nature and scope of the credit institution's activities, the following risks have to be addressed:

a. credit
b. market
c. operating or transactions
d. reputation
e. strategic
f. compliance and legal
g. liquidity.

Sound management practices comprise active oversight by the Board of Directors and management, and by relevant and suitably qualified personnel. Such practices also include the implementation of adequate policies, processes and controls, taking into consideration the size and sophistication of the credit institution, appropriate audit programs, internal control environment, effective risk monitoring and management information systems. This rating reflects the Board and management's ability as it applies to all aspects of banking operations as well as other financial activities. Furthermore, credit institutions should also comply with the code of principles of Good Corporate Governance which are appended to the Malta Stock Exchange listing requirements.

(v) *Earnings*

This rating reflects the level, trend and stability of earnings, as well as factors that affect their sustainability or quality. The quantity and quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses that would require additional provisions accordingly. The quantity and quality of earnings can also be highly affected by the levels of market risk that may expose the institution to undue volatility in interest rate and currency. The quality of earnings may also be affected by undue reliance on extraordinary or exceptional gains, non-recurring events, or favourable tax treatment. Future earnings may be adversely influenced by an inability to forecast or control funding requirements, operating expenses, inadequacy of loan loss reserves, improperly executed or ill-advised business strategies, or other poorly managed or uncontrolled risk exposures.

(vi) Liquidity

Consideration should be given to the current level and prospective source of liquidity compared to funding needs. The adequacy of fund management practices relative to the institution's size, complexity and risk profile have to be evaluated as well. In general, fund management practices should ensure that an institution is able to maintain sufficient liquidity to meet financial obligations in a timely manner, while fulfilling legitimate banking needs. These practices should reflect the institution's ability to manage unplanned changes in funding sources, as well as react to changes in market conditions by liquidating assets with minimal losses. Additionally, liquidity practices must be commensurate with costs, and not maintained through unduly relying on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

(vii) Sensitivity to Market Risk

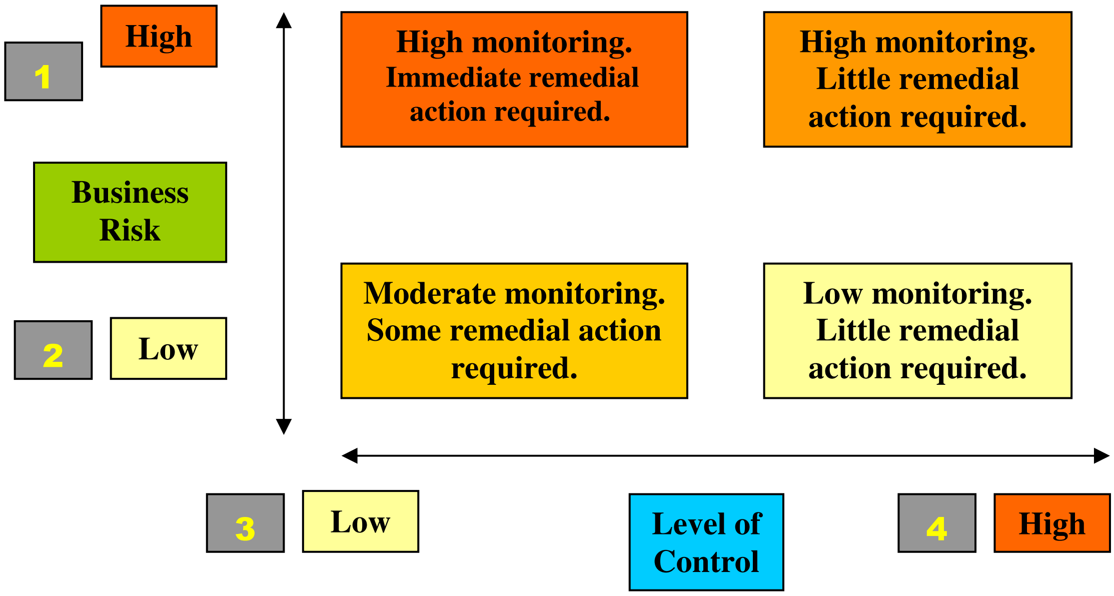
Sensitivity to market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices or equity prices can adversely affect the credit institution's earnings or capital. Consideration should be given to:

i. management's ability to identify, measure, monitor, and control market risk
ii. the institution's size
iii. the nature and complexity of operations
iv. the adequacy of capital and earnings in relation to the credit institution's level of market risk exposure.

Whilst the primary source of market risk in many credit institutions arises from non-trading positions and their sensitivity to changes in interest rates, larger credit institutions may have additional foreign operations which give rise to significant market risk. Trading activities in other credit institutions may be a major source of market risk.

Rating reports that are drawn up on the basis of the above criteria are not normally disclosed to the licence holder in question. However, the Banking Supervision Unit could, if deemed necessary, discuss such reports in whole or in part with the licence holder concerned.

Through the CAMELS analysis, the Banking Supervision Unit is able to formulate a risk-rating profile of a credit institution. This will, as mentioned earlier, guide the supervisory authority in its on-site inspection programme, as well as indicate any remedial action that the supervised credit institution is required to undertake. As stated earlier, the intensity of focus by the on-site Inspectors depends to a large extent on the risk-profile of the particular credit institution. The higher the risk and the lower the controls, the larger is the level of monitoring. This is depicted in the diagram below:



A licence holder with a low level of risk but with a high level of control (2,4) normally requires a limited level of supervisory monitoring. However, entry into new business activities may necessitate a moderate level of control.

A well-controlled licence holder, whose business risks may be high (1,4), may require an on-going level of monitoring to ensure that the risks are kept under control, and the risk profile remains acceptable and does not pose any systemic risk due to its high business risks.

A licence holder whose business risk is low but whose controls are weak (2,3) would require some remedial action to ensure that proper controls are in place commensurate with the risks undertaken. The level of awareness and compliance by its management as well as the impact on the local financial system may influence the frequency of inspections.

A licence holder with a high-risk profile and a low level of control (1,3) presents the greatest risk. Such a situation may necessitate immediate remedial action under close supervisory attention. The focus will be on the management's ability to resolve problems by taking necessary action and monitor progress. The level of risk in this situation will normally be monitored on a continuous basis.

Apart from the CAMELS based analysis, the report also includes a regulatory assessment of the bank's business developments and any observations that may be necessary on feedback received from the Central Bank concerning the performance of the bank in areas of operations directly concerning the Central Bank (for example financial stability, payment systems, open market and money market operations).

Furthermore, the methodology (Risk Rating) report also serves as a basis for periodic meetings that the Banking Supervision Unit holds with the entire Board of Directors of banks in order to discuss matters of regulatory interest.

7.1.0 PEER GROUP ANALYSIS

A peer group analysis is undertaken on the basis of financial ratios for a group of banks taken together in order to ascertain whether an individual bank is performing significantly different from its peers. In these cases, the analysis also tries to establish the reason for such a divergence by the outlier. The peer group is normally categorized by asset size or the type of business it undertakes.

This report is compiled periodically by the Methodology Section to identify any outliers and establish the reason for this performance being outside the expected norm and systematically analyse the banking sector across selected fields. Stress testing and scenario analyses are also included in the Report in order to determine the expected condition of each bank under adverse financial or economic conditions.

8. OTHER RETURNS AND REPORTS

In order to assess various other categories of risk, the Banking Supervision Unit also receives other returns and draws up specific reports as may be required from time to time. These include:

Foreign Currency Exposure Return
Adverse movements in exchange rates may give rise to potential foreign exchange losses in exposures held in foreign currency (whether due to long or short positions). Depending on the extent of the exposure, these losses can be significant, particularly during periods of exchange rate volatility. In order to assess the impact of foreign exchange exposure on an institution's profitability and own funds, the Banking Supervision Unit reviews the credit institution's position to ensure whether institutions are adhering to the prudential limits as established in accordance with the monthly return submitted to the Banking Supervision Unit in terms of the relevant Article in Annex 1 (Foreign Exchange Risk) of Banking Rule BR/08 on Capital Adequacy. The Article provides for the MFSA to set limits in relation to assets that a licence holder could hold in foreign currency. Such limits may be set by the MFSA for prudential reasons as appropriate on a case-by-case basis. Apart from this requirement, which is normally applicable to credit institutions, other licence holders (financial institutions) submit daily and weekly foreign exchange positions to the Middle Office of the Central Bank. In addition, other licence holders are also required to submit an end-of-month return of assets denominated in foreign currencies to the Banking Supervision Unit. An arrangement is also in place whereby the Banking Supervision Unit and the Central Bank advise each other whenever it comes to their notice that foreign asset limits have been exceeded during the interim period.

9. BI-LATERAL AND TRI-LATERAL MEETINGS

As stated in Paragraph 6.2.0, in order to increase the on-going co-ordination between External Auditors of licensed institutions and the Banking Supervision Unit, the External Auditors' letter to management is copied to the Banking Supervision Unit. This letter, together with the institution's reply thereto, is analysed in the light of any concerns or weaknesses as well as any new developments.

Furthermore, the Banking Supervision Unit, through its Regulation and Compliance Section, also analyses the published audited financial statements of licence holders. A report including any observations of note as well as an analysis indicating the level of adherence to Banking Rule BR/07 on the Publication of Financial Statements is compiled. The above analysis could also lead to the holding of tri-lateral or bi-lateral meetings with the credit institutions and their External Auditors in terms of Section 25 (7) of the Banking Act 1994.

10. CONTINGENCY PLANNING

The purpose of contingency planning is to ensure that in the event of a crisis, co-ordinated action is taken by the MFSA in conjunction with the Central Bank to preserve the confidence and stability in the Maltese financial system. The resultant mutual co-operation helps both parties to identify the actions that need to be taken during a crisis. This may lead to prompt and complete action being taken to address such crisis.

For this purpose, the contingency plan which has been issued jointly by the MFSA and the Central Bank defines the nature of a crisis and the categories of possible events. The plan also specifies the different possible responses to address the situation according to its degree of impact. As such, responses can be *routine, serious,* or *urgent.* The extent of response to a situation or event is gauged by the impact it can have on the institution as follows:

i. *Routine* - An incident in which the impact on the system is assessed as low. Routine incidents in which the potential for an increase in severity is high are classified as serious.
ii. *Serious* - An incident in which the impact on the system is assessed as moderate. Serious incidents in which the potential for an increase in severity is high are classified as urgent.
iii. *Urgent* - An incident in which the impact on the system is assessed as high.

Any anticipated event is assessed also on the basis of *probability, impact,* and *severity* within a *high, moderate* or *low* scale attached to each of the three factors. The basis on which these factors are determined are specified hereunder:

a) *Probability* - The assessment of the probability of each event occurring is determined mainly on the basis of past experience and emerging circumstances.
b) *Impact* - The impact of a possible event is determined by assessing the potential implications on public confidence and on the capacity of the system to respond.

c) *Severity* - The assessment of potential growth in severity is based on the rate at which an event could de-stabilise the system.

The Contingency Plan also describes the response process and identifies the supervisory personnel with all relevant details, the contact persons of supervised institutions, as well as the necessary information and details of External Auditors.

In May 2005, the Memorandum of Understanding (MOU) on co-operation between banking supervisors, central banks and finance ministries of the European Union was signed. Pursuant to the above, the MFSA, the CBM and the Ministry of Finance set up a high level Working Group to prepare a framework which could be utilized in case of a financial crisis. The Group meets regularly with a view to drawing up such a framework. The Group has also participated in a simulation exercise organised by the Economic and Financial Committee of the European Commission which included representatives from signatories of EU member states.

11. CO-OPERATION AND SHARING OF INFORMATION

11.1.0 MoUs with the Central Bank of Malta

The MFSA and the Central Bank acknowledge that they have crucial roles to play in the establishment of a sound financial system in Malta. The MFSA is responsible *interalia* for the regulation and supervision of credit institutions. It is also responsible to ensure high standards of conduct by such institutions. The Central Bank, on the other hand, is entrusted among other matters with the duties of ensuring the stability of the financial system, of promoting the establishment of sound and efficient payment systems, to influence the volume and conditions of supply of credit and to promote the orderly and balanced economic development in Malta. From the foregoing, it follows that the MFSA and the Central Bank need to have in place mechanisms to ensure timely exchange of information and to foster co-operation for both institutions to achieve their objectives in terms of law.

In view of the above, a Memorandum of Understanding (MoU) has been drawn up between the Central Bank and the MFSA. This MoU was signed on 4th February 2003. The MoU is based on the principle that while the respective parties are responsible and accountable for the areas assigned to each of them by law, the MFSA and the Central Bank will assist each other in the fulfilment of their duties through a mutual exchange of information within the parameters assigned by law.

The areas covered by the MoU are:

- the obligation of professional secrecy in respect of information acquired by any party
- responsibilities and functions of the MFSA and the Central Bank
- the power to obtain and exchange information
- the establishment of a Standing Committee made up of members from both parties
- the manner in which communication should be undertaken
- co-operation in international relations

- responsibilities for record maintenance.

Following this, in May 2003, the MFSA and the CBM signed a second MoU in relation to Payments and Securities Settlements Systems.

11.2.0 MOUS WITH OTHER REGULATORY AUTHORITIES

The MFSA has signed a number of bilateral MoUs with foreign counterparts with the aim of facilitating the exchange of regulatory information and to create a formal framework for regulatory collaboration and co-operation. The Banking Supervision Unit has put to good use the contacts that the MFSA has managed to make with officials from these foreign counterparts, especially when conducting due diligence exercises in relation to new applicants as well as to obtain information about foreign groups which have established a presence locally and regarding which there may be supervisory or regulatory issues.

11.3.0 COMMITTEE OF EUROPEAN BANK SUPERVISORS (CEBS)

The Banking Supervision Unit is represented, through its Director, on the CEBS, which is a high level committee where supervisors from member countries of the EU meet on a quarterly basis. The CEBS is a Committee which has as its main goal that of discussing and formalizing guidelines which will promote convergence of day-to-day supervisory approaches. CEBS benefits from an open and transparent consultation process between supervisors and as such, the Committee's pursuit of identifying good international supervisory practices and encouraging its members to adopt them in a convergent and consistent manner appears to be having the desired effect

11.4.0 GROUPE DE CONTACT (GDC)

The GdC is a subcommittee of the CEBS and is also regularly represented by one of the Banking Supervision Unit's Deputy Directors during its quarterly meetings. Being one of the main subgroups of CEBS, this forum discusses issues which relate to supervisory and regulatory procedures from a more technical level. Such procedures are then implemented through the CEBS itself.

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