

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

**THE FRAMEWORK OF
SUPERVISION
FOR
FINANCIAL INSTITUTIONS**

BANKING SUPERVISION UNIT

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The scope of this document is to focus on how the Banking Supervision Unit conducts its supervisory role in terms of its off-site and on-site surveillance once financial institutions are licensed.

The terms “financial institutions”, “licence holders” and “regulated entities” as referred to throughout the Framework are to be considered as interchangeable.

THE FRAMEWORK OF BANKING SUPERVISION

BANKING SUPERVISION UNIT

1.0.0 INTRODUCTION

The objective of the Framework of Supervision of financial institutions is to provide a detailed description of the risk-based approach for the supervision of financial institutions authorised under the Financial Institutions 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 regulatory and supervisory role. Through the regulatory and supervisory process, problems within such institutions can be identified and remedial action recommended for action to be taken by the institution's management. Nonetheless, it should be emphasised that the responsibility of each financial institution 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 financial institutions in terms of the risks faced by the institutions themselves and those that could arise from general instability in the financial market. 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.

2.0.0 REGULATED ENTITIES

The entities regulated by the Banking Supervision Unit include financial institutions licensed under the Financial Institutions Act 1994. In terms of the Financial Institutions Act, financial institutions are considered as those institutions which offer

some form of financial service to the public as defined in the Schedule to the Act, but not including deposit taking or the provision of investment services.

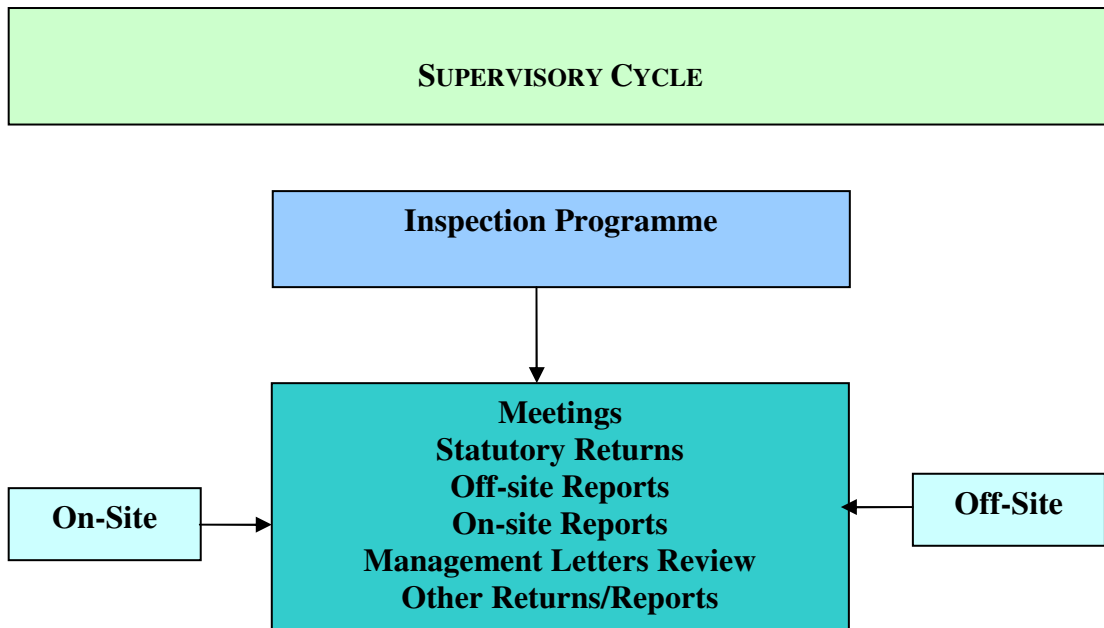
3.0.0 THE BANKING SUPERVISION UNIT

The Financial Institutions Act 1994 provides the framework of responsibilities and objectives of the Banking Supervision Unit insofar as financial institutions are concerned. This Act is reinforced by Financial Institutions Rules and Legal Notices, together with a number of Policy Papers that are issued from time to time in order to strengthen the supervision and regulation 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 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 three mutually dependent sections namely:

- A) **Off-site Supervision** 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.
- 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 Financial Institutions Act 1994, Notices on matters relevant to the conduct and management of financial 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 risks on a continuous basis.
- Verifying that financial institutions 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 financial 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 creditors, the financial system, and/or against the provisions of the Financial Institutions 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.

4.0.0 ANNUAL INSPECTION PROGRAMME

In consultation with the Director in charge of the Banking Supervision Unit, the On-Site Section prepares an annual inspection programme prior to the beginning of each year. This programme, which will include reviews at both credit as well as financial institutions 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 primarily be based on the outcome of the analysis of risks as identified by the Off-Site 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 would naturally be focused on credit institutions and the specific risks to which each of these may be mostly exposed. It should however be stressed that the Inspectors do not in any way neglect financial institutions – due attention is thus given to such institutions in accordance with the risks which the Authority perceives that these may pose to the local financial system (refer to Section 6.0.0).

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*).

5.0.0 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 as and where applicable.

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.

5.1.0 MONTHLY/QUARTERLY REPORTS

The individual financial 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 institutions and/or the system as a whole.

The monthly/quarterly report also includes balance sheet summaries, a number of accounting ratios and other 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 could normally result in *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 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.

The monthly/quarterly report is circulated within the Banking Supervision Unit for any further comments or action as may be 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.

The monthly /quarterly off-site reports on 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 to assess the soundness of an institution, identification of regulatory concerns and its observation of legal requirements. However other factors may be taken into consideration if deemed appropriate in particular circumstances. A brief description of the CAMEL factors is given hereunder.

Capital - the evaluation of capital includes the institution's adequacy to support its business through adequate capital and will normally include assessment of own funds, loan loss reserves (if applicable), solvency ratio and capital adequacy ratio insofar as the foreign exchange risk is concerned.

Assets/Liabilities – this involves the examination of the composition, quality, concentration and possibly provisions of the securities and lending portfolio on the one hand and the funding structure on the other.

Management – the possibility to assess the quality of management of licence holders through the submission of statutory financial information is limited. However, it is possible to assess management through other criteria such as timeliness of submission of such returns, quality of reporting, ability to answer queries, level of understanding of risks through correspondence and meetings.

Earnings – the Inspectors' evaluation of an institution's profitability has to be made in the light of the quality and reliability of the institution's current earnings profile and will include an assessment relating to changing economic circumstances and volatility of earnings, taking also account of expenses, amongst others.

Liquidity – In assessing liquidity, the Inspectors examine the maturity ladder, the quality of the institution's assets and compliance with any relevant Banking Rules.

6.0.0 ON-SITE SUPERVISION

An important element of supervision is the evaluation, on an on-going basis, of the various risks to which an 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 is normally the main source 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. **Risk Identification** - an initial study of information available to identify the licence holder's risk profile.
- ii. **Analysis 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. **Communication 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. **Effectiveness** - 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 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 supervisory or international bodies such as the Basel 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 on-site reports
- iv. any relevant internal checklist
- v. questionnaire replies related to previous inspections
- vi. background correspondence.

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 subsequently 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 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 on whether or not to utilise 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 Deputy Director On-Site Section in order to discuss and approve the procedures as planned by the inspection team.

In those instances where the institution to be reviewed is also licensed by any other unit within the MFSA, it is customary to advise the Securities Unit, the Insurance Business 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 all 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, the Deputy Director On-Site Section, is also handed in during this 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 (if the licence holder has its own internal audit function) in order 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 inspection process will be aimed at analyzing the internal controls which have been put in place by the institution to mitigate the risks to which it may be exposed. The Inspection review will also assess adherence to licence conditions and other statutory and regulatory obligations.

During the inspection process at financial institutions, the Inspectors carry out an analysis of internal controls related to prevention of money laundering and finance of terrorism (PMLFT). Note should be made that in relation to PMLFT, 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 also be instructed to carry out specific PMLFT inspections at any of the licensed financial 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 communicate with the financial institution concerned as to the course of action it is to take. Alternatively, the MFSA Inspectors will carry out reviews in line with their Annual Inspection Programme and will forward the relevant section(s) of the Inspection Report relating specifically to PMLFT to the FIAU for the latter to take any action as deemed necessary from their end. Any action taken or recommended by the FIAU following an inspection exercise is communicated to the Banking Supervision Unit. The entire Report will, in such cases, be forwarded to the institution concerned directly by the MFSA.

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 (if applicable), the external auditor and at least one 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 Managing Director (or equivalent) of the institution examined, accompanied by a letter explaining the highlights of the report and any required remedial action. This officer 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 Banking Supervision Unit, declaring that they have perused the report in their capacity as Directors of the institution.

The Director Banking Supervision 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. In this regard, members of an institutions' Board of Directors have to give due attention so as to adhere to internationally recognized governance principles and more specifically to the Principles of Good Corporate Governance issued by the MFSA. 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.

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), relevant EU Directives, CEBS Guidelines/High Level Principles and the corresponding Financial Institutions Rules and Policy Papers 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 a particular 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.

7.0.0 OTHER RETURNS AND REPORTS

In order to assess various other categories of risk, the Banking Supervision Unit may also request other returns from licensed institutions and the latter may be required to draw up specific reports as necessary from time to time.

8.0.0 BI-LATERAL AND TRI-LATERAL MEETINGS

As stated in *Section 6.2.0*, in order to increase the on-going co-ordination between External Auditors of licensed financial 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 (where applicable) is compiled. The above analysis could also lead to the holding of tri-lateral or bi-lateral meetings with institutions and their External Auditors in terms of Article 20 (7) of the Financial Institutions Act 1994.

9.0.0 MOUS WITH OTHER REGULATORY AUTHORITIES

9.1.0 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, *inter alia* for the regulation and supervision of financial institutions. It is also responsible to ensure high standards of conduct by such institutions. The CBM, on the other hand, is responsible, amongst others, for the stability of the financial system. As such the MFSA and the CBM need to have in place mechanisms to ensure that timely exchange of information and to foster co-operation for both institutions to achieve their objectives according to the relative legislation.

In view of the above, the MFSA and the CBM signed a Memorandum of Understanding (MoU) on 4th February 2003. This MoU is based on the premises and principles as described in the previous paragraph and cover the following areas:

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

9.2.0 FOREIGN REGULATORS

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.

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MFSA

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