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Policy Document

On the methodology for the identification of other systemically important institutions and the related capital buffer calibration

**THE CONTENTS OF THIS DOCUMENT ARE NO LONGER APPLICABLE AND HAVE BEEN REPLACED BY
A REVISED VERSION OF THE POLICY DOCUMENT ON THE O-SII METHODOLOGY, PUBLISHED ON
20TH JANUARY 2020 AND AVAILABLE VIA THIS [LINK](#)**

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Executive summary

This Policy Document defines the methodology for the identification of Other Systemically Important Institutions (O-SIIs) and the calibration of the related capital buffer.¹ The O-SII buffer is a macro-prudential tool that aims to strengthen the resilience of the domestic financial system to systemic risk arising from misaligned incentives and moral hazard. This tool will increase the loss-absorbing capacity of institutions that are deemed of high systemic relevance, buttressing further the system from institution-specific and sector-wide shocks. The CRDIV/CRR framework provides the legal background for the identification of systemically important institutions in EU Member States (CRD Article 131). The responsibility for the domestic implementation of this Article is shared jointly between the Central Bank of Malta (CBM) and the Malta Financial Services Authority (MFSA) (hereunder referred to as “the authorities”) as per LN 29 of 2014 (S.L.204.06). As per Article 162(2), the O-SII buffer shall apply from 1st January 2016.

In line with CRDIV, the framework outlined in this Policy Document applies to all credit institutions, investment firms, and parent financial (or mixed financial) holding companies within the domestic financial sector at their highest level of consolidation in Malta.

The framework for the implementation of an O-SII buffer involves (a) the identification of institutions as O-SIIs; and (b) the calibration of the buffer rate which will be applied to identified O-SIIs.

Within the scope of the identification methodology adopted by the authorities through the Joint Financial Stability Board (JFSB) and in line with CRDIV Article 131, as a first step, systemically important institutions are to be identified and assessed on the basis of their relative importance within the sector based on the following criteria:

- a) Size;
- b) Substitutability;
- c) Cross border activity; and
- d) Resident interconnectedness.

The higher the score, the more important the institution is within the sector. The identification methodology also includes a second step whereby authorities assess whether further institutions should be designated as O-SIIs based on additional absolute indicators. In both steps, indicators were selected such that they adequately capture systemic risk domestically.

The capital buffer calibration methodology relies on the resultant O-SII scores. Based on these scores, O-SIIs are allocated to different buckets attracting different buffer rates. The O-SIIs with the highest scores are allocated to the higher bucket while the O-SIIs with the lowest scores are allocated to the lower buckets, subject to pre-determined thresholds and criteria.

¹This follows a CBM and MFSA consultation <https://www.centralbankmalta.org/notifications> launched in November 2015.

1.0 Introduction

This Policy Document provides a framework for the operationalisation of the Other Systemically Important Institution (O-SII) capital buffer, which is aimed at mitigating the vulnerability of the domestic financial system and the real economy to the failure of systemically important institutions. The O-SII buffer consists of a capital surcharge applied to institutions that may, in the event of failure or impairment, have considerable impact on the financial system and the real economy. This additional capital buffer is applied to domestically significant institutions to increase their resilience by increasing their loss absorbing capacity and thus ensure that they pose minimal risk to the domestic economy in the form of externalities. Market failures targeted by the O-SII capital buffer mainly relate to the excessive risk-taking due to expectations of a bailout as a result of the perceived systemic relevance of an individual institution (moral hazard and 'too big to fail'). In this respect, the O-SII buffer is a macro-prudential instrument that contributes to the development of financial stability by mitigating the structural element of systemic risk stemming from moral hazard.

The O-SII buffer is an essential element of the ESRB Recommendation on the intermediate objectives and instruments of macro-prudential policy, and is a macro-prudential tool legally embedded in the CRDIV/CRR framework which, in turn, has been domestically transposed in CBM Directive no 11 and MFSA Banking Rule no 15.

In line with such requirements, this Policy Document establishes a framework for the development and application of the O-SII buffer within the domestic macro-prudential framework.

2.0 The identification of O-SIIs

In line with Article 131 of the CRDIV, the O-SII framework outlined in this Policy Document shall be applied in relation to all entities subject to the CRDIV/CRR on a consolidated basis. Identified O-SIIs will be required to hold an O-SII buffer at the highest level of consolidation in Malta.

3.0 Framework for O-SII identification

Step 1

O-S IIs are identified in line with a methodology based on the criteria, indicators and weightings included in Table 1. Annex 1 provides an overview of the rationale for selecting the indicators of domestic relevance listed in table 1.

Table 1: Scoring Methodology for domestic O-SII identification

Criterion	Indicators	Weight	
Size	Total assets	20.00%	20%
Substitutability	Resident customer loans	13.33%	40%
	Resident customer deposits	13.33%	
	Holdings of Government debt	13.33%	
Cross-border activity	Cross-border assets	10.00%	20%
	Cross-border liabilities	10.00%	
Resident Interconnectedness	Resident Interbank assets	10.00%	20%
	Resident Interbank liabilities	10.00%	

Absolute values for the indicators are used in the computation, which, following comparison with the industry totals, provide the relative importance of an entity compared to its peers, for that specific indicator, criteria and overall. Various methods and statistical computations have been tested in order to best reflect domestic specificities. A standard z-score model is being used in order to limit subjectivity in the interpretation of results and to normalise the values across entities.

More specifically, a standard z-score is computed, indicating the distance from the mean for each entity in each indicator. A simple average of the standard z-scores is computed across the indicators in each criterion so as to give the score of each indicator within any given criterion an equal weight. The overall result is obtained by applying a weighted average across the four criteria, with the highest weight assigned to substitutability. Institutions with an overall result exceeding the value of 1, i.e. beyond one standard deviation from the mean, are considered O-SIIs based on the selected criteria.

Step 2

Once the scoring methodology proposed under Step 1 above is undertaken, institutions that do not qualify under Step 1 shall be subject to a second step. This step is important since the relativity incorporated in Step 1 does not fully capture the importance to the domestic economy, that a specific credit institution may have i.e. whilst being small when compared to its peers a credit institution may still be systemically relevant to the domestic economy and its failure may create systemic risk. To operationalise this step, the following two criteria with the respective thresholds were adopted:

1. Size \geq 25% of domestic GDP; and
2. Covered Deposits \geq 2.5 times the domestic Depositor Compensation Scheme (DCS) funding.²

An institution that meets both criteria listed in point 1 and 2 above would qualify as an O-SII. This step reflects a credit institution’s potential to affect adversely the stability of the system through its size relative to domestic GDP and the size of its covered deposits relative to the domestic DCS funding. A credit institution that meets or exceeds the thresholds set in both point 1 and 2, is added to the list of O-SIIs and may thus be subject to an O-SII capital buffer.

²Covered Deposits is defined as per Article 2(1)(5) of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.

4.0 Capital buffer calibration

The proposed bucketing methodology (table 2) is based on the scores achieved in the O-SII identification stage in Step 1, as follows:³

1. the highest bucket remains the maximum legal O-SII buffer rate of 2%, whilst the lowest is set at 1.0%.⁴
2. buffer rates are allocated into three buckets in steps of 0.5% as per table 2,
3. the overall score obtained in the identification methodology (Step 1) is used to indicate the bucket in which an institution is allocated, starting from bucket 1 in table 2.

Table 2: The Bucketing Methodology – Step 1

Buckets	Capital Buffer rate	Criterion for each bucket
3	2.0%	High risk due to most of the criteria and/or Score equal to or above 1.75
2	1.5%	Risk due to most of the criteria and/or Score equal to or above 1.25 and below 1.75
1	1.0%	Some risk due to some criteria and/or Score equal to or above 1 and below 1.25

For institutions that qualify as O-SIIs via Step 2, a capital buffer rate of 0.5% shall apply as per table 3.

Table 3: Capital buffers for Step 2

Capital Buffer rate	Criterion
0.5%	Additional Indicators

5.0 Application

The O-SII capital buffer becomes effective as from 1 January 2016 and shall be reviewed on an annual basis. An institution shall cease to qualify as an O-SII if for two consecutive years it does not exceed the established thresholds in either step 1 or step 2, unless otherwise determined by the authorities.

³BCBS (2011). Global systemically important banks: Assessment methodology and the additional loss absorbency requirement. Basel.

⁴CRDIV Article 131 para 5 states that the relevant authorities may require each O-SII, on a consolidated or sub-consolidated or individual basis, as applicable, to maintain an O-SII buffer of up to 2% of the total risk exposure amount calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013, taking into account the criteria for the identification of the O-SII. That buffer shall consist of and shall be supplementary to Common Equity Tier 1 capital.

Annex 1: Selection of Indicators

The indicators of domestic relevance have been selected following this rationale:

- **Size**

An indicator of total assets is used to measure the size of the credit institution within the sector.

- **Substitutability**

The second criterion measures the importance of each institution vis-à-vis the others. Three indicators are considered appropriate for measuring domestic relevance: (i) resident customer loans, excluding interbank; (ii) resident customer deposits, also excluding interbank; and (iii) holdings of domestic Government debt. The rationale is to obtain a measure of the potential impact that the failure of an institution could have on the financial sector when compared to its peers. The larger and more unsubstitutable an institution is, the larger the moral hazard and the impact in an adverse scenario. The assessment of sovereign exposures is considered important given that problems arising in an institution that is highly exposed to the domestic sovereign may have negative implications for domestic government funding.

- **Cross-Border Activity**

A significant external element on an institution's balance sheet would act as a contagion channel of cross-border systemic risk. In this respect, an institution may not be large by asset size but significant through its element of external activities. In order to quantify this criterion, two indicators are selected: (i) cross-border assets; and (ii) cross-border liabilities. These incorporate all operations on the institutions' balance sheets that are not conducted with residents.

- **Resident Interconnectedness**

Furthermore, it is considered appropriate to also incorporate a measure of domestic interbank exposure in order to gauge the extent of potential contagion not only cross-border but also between banks operating domestically. Two indicators are included: (i) resident interbank assets; and (ii) resident interbank liabilities. In view of the short-term nature of these indicators and the inherent volatility, a 24-month average was used as opposed to one data point as at June 2014.