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MFSA MALTA FINANCIAL SERVICES AUTHORITY

Policy Document

On the revised methodology for the identification of other systemically important institutions (O-SIIs) and the related capital buffer calibration

January 2020

Executive summary

This policy document supersedes the 2016 other systemically important institutions (O-SII) methodology and thus, presents a new revised framework for the identification of O-SIIs and the related capital buffer calibration. This revised framework also brings the methodology more in line with the European Banking Authority (EBA) Guidelines on the criteria to assess O-SIIs.

The CRDV/CRRII framework requires the identification of systemically important institutions and the setting up of corresponding capital buffers, known as the O-SII buffer, to enhance the loss absorbing capacity of such institutions and hence limit the propagation of risk onto the domestic financial system.[1] Thus, the aim of this macroprudential measure is to further strengthen the financial system from institution-specific (including moral hazard) and sector-wide shocks.

The implementation of the framework for an O-SII buffer as per Article 131 CRDV involves: (a) a methodology for the identification of institutions as O-SIIs; and (b) a methodology for the calibration of the buffer rate which will be applied to identified O-SIIs.

On 1 January 2016, the Central Bank of Malta (CBM) jointly with the Malta Financial Services Authority (MFSA) ('the Authorities') introduced for the first time a Policy Document on the identification of O-SIIs and the calibration of the related capital buffer.

Within the scope of the revised identification methodology adopted by the Authorities through the Joint Financial Stability Board (JFSB) and in line with the then CRDIV Article 131, as a first step, systemically important institutions are identified and assessed on the basis of their relative importance within the financial sector based on a set of specific categories and indicators. These categories and indicators are based on those put forward in the EBA Guidelines. Additional indicators outlined in Annex 2 of the EBA Guidelines have also been included to account for the specificities of the domestic financial sector. The higher the resultant score, the more important the institution is within the sector, reflecting greater risk posed to the domestic financial system and the real economy in case of failure of the institution. Meanwhile, the calibration stage is based on the scores obtained during the identification stage.

Within the framework of the EBA methodology, this revised framework reflects more the domestic specificities of the financial system and is now deemed more suitable in terms of the plausibility of its results within the current local context. The methodology encompasses the identification criteria for an O-SII on the basis of a pre-determined threshold of 425 bps, established in accordance with the leeway provided in the EBA Guidelines. If an institution's overall weighted average score is equal to or above this given threshold, such institution will be classified as an O-SII. Furthermore, based on the level of the scores exceeding the threshold, O-SIIs will be allocated to different buckets attracting different buffer rates, i.e. the O-SIIs with higher scores will be allocated to higher buckets, while the O-SIIs with the lower scores will be allocated to lower buckets, subject to pre-determined thresholds and criteria.

This revised framework is effective as from January 2020.

[1] It is to be noted that the provisions of the CRDV/CRRII referred to in this Policy Document would come into effect from 29 December 2020/28 June 2021

1.0 Introduction

The CRDV[2]/CRRII[3] framework provides the legal background for the identification of systemically important institutions in EU Member States (Article 131 CRDV – 'Global and other systemically important institutions'). Pursuant to regulation 2(2) of the Central Bank of Malta Act (Appointment of Designate Authority to implement Macro-Prudential Instruments) Regulations (S.L. 204.06 of the Laws of Malta), 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) (hereinafter referred to as 'the Authorities').

The other systemically important institutions (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 domestic institutions identified as O-SIIs to increase their resilience by increasing their loss absorbing capacity and thereby ensuring that they pose minimal risk to the domestic economy in the form of externalities. Market failures targeted by the O-SII 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, thereby promoting market discipline.

The O-SII buffer is an essential element of the ESRB Recommendation on the intermediate objectives and instruments of macro-prudential policy,[4] and is a macro-prudential tool legally embedded in the CRD/CRR framework which, in turn, is domestically transposed in CBM Directive No. 11[5] and MFSA Banking Rule No. 15.[6]

The Authorities periodically assess the methodology and during 2019's iteration, decided to revise and update the 2016 O-SII Methodology. The objectives behind this revision are to better reflect the developments in the domestic financial sector and to further align the domestic O-SII methodology with the EBA Guidelines,[7] with a view to implement the revised methodology as from January 2020.

This policy document presents the revised framework for the O-SII identification methodology. Firstly, section 2.0 outlines the entities which can be designated as O-SIIs. Section 3.0 presents the revised O-SII identification methodology which entails the adoption of the mandatory indicators stipulated in the EBA

[2] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending the Capital Requirements Directive IV as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

[3] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending the Capital Requirements Regulation as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements.

[4] Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1):
https://www.esrb.europa.eu/pub/pdf/recommendations/2013/ESRB_2013_1.en.pdf

[5] Directive No. 11 – Macro-prudential Policy

[6] BR/15/2015 Capital Buffers of Credit Institutions Authorised under the Banking Act 1994

[7] https://eba.europa.eu/sites/default/documents/files/documents/10180/930752/964fa8c7-6f7c-431a-8c34-82d42d112d91/EBA-GL-2014-10%20%28Guidelines%20on%20O-SIIs%20Assessment%29.pdf?retry=1

Guidelines, as well as additional indicators (listed as optional indicators under Annex 2 of the EBA Guidelines), which are deemed to better reflect the specificities of the domestic financial sector. In addition to the identification methodology, the revised framework also outlines a bucketing approach as part of the O-SII calibration process which will then be used to calibrate the O-SII capital buffer rate, discussed in section 4.0. Section 5.0 then outlines the transitional provisions, while section 6.0 concludes with details on the application date and next steps.

2.0 Entities that can be identified as O-SIIs

In line with Article 131 of the CRDV, the O-SII framework outlined in this policy document is to be applied to all entities subject to the CRDV/CRRII framework on an individual, sub-consolidated or consolidated basis, as applicable. Identified O-SIIs will be required to hold an O-SII buffer at the highest level of consolidation in Malta.

3.0 Revised methodology for O-SII identification

Step 1

O-SIIs are identified in line with the EBA Guidelines based on a core set of criteria (categories), indicators and weights as per table 1. Annex 1 outlines the rationale for adopting these categories and respective indicators, while highlighting the motivations behind the inclusion of EBA optional indicators.

Table 1: Scoring Methodology for domestic O-SII identification

Category	Indicators	Indicator weight	Category weights
Size	Total Assets	22.00%	22.00%
Importance	Value of domestic payment transactions	8.00%	40.00%
	Private sector deposits from depositors in the EU*	5.50%	
	Private sector loans to recipients in the EU**	5.50%	
	Private sector deposits from Maltese residents	10.50%	
	Private sector loans to Maltese residents	10.50%	
Complexity	Value of OTC derivatives (notional)	4.00%	18.00%
	Cross-jurisdictional liabilities	7.00%	
	Cross-jurisdictional claims	7.00%	
Interconnectedness	Intra-financial system liabilities	9.00%	20.00%
	Intra-financial system assets	9.00%	
	Debt securities outstanding	2.00%	

* MT deposits are incorporated in ‘private sector deposits from depositors in the EU’ indicator.

** MT loans are incorporated in ‘private sector loans to recipients in the EU’ indicator.

In line with the EBA Guidelines, the Authorities calculate the score in basis points (bps) for domestic institutions by:

(a) dividing the indicator value of each individual relevant entity by the aggregate amount of the respective indicator values summed across all domestic institutions (the 'denominators');
(b) multiplying the resulting percentages by 10,000 to express the indicator scores in terms of basis points;
(c) calculating the category score for each relevant entity by taking a weighted average of the indicator scores in that category;
(d) calculating the overall score for each relevant entity by taking a weighted average of its four category scores.

As per EBA Guidelines, institutions with a score equal to or higher than 350 bps should be designated as O-SIIs. However, the EBA Guidelines also allow for a +/- 75 bps leeway to either increase the threshold to 425 bps, or decrease the threshold to 275 bps. The revised identification methodology establishes the cut-off threshold point at 425 bps to reflect Malta's relatively small financial sector and high concentration levels due to a small number of market participants.

Step 2

The EBA Guidelines put forward a number of optional indicators which Member States may adopt to complement the initial set of indicators to reflect the specificities of each national financial sector. In this regard, the Authorities have assessed a number of optional indicators under Annex 2 of the EBA Guidelines and decided to incorporate 'Private Sector Deposits from Maltese residents' and 'Private Sector Loans to Maltese residents' as indicators under the 'Importance' category. These additional indicators are incorporated in the 'Importance' category to account for the specificities of the Maltese financial sector; in particular, the strong orientation towards domestic deposits and loans.

Annex 2 illustrates a numerical example showing the scores for four hypothetical banks (in basis points). The results show the scores for each category, inclusive of the additional indicators and the resultant overall weighted average scores. To note, that the example provided is based on hypothetical data and should therefore not be seen as reflecting the scores of any specific credit institution/s.

Annex 3 provides an overview of the 2016 O-SII methodology.

4.0 Capital buffer calibration

The identification methodology outlines the degree of systemic risk exerted by a particular O-SII. Credit institutions identified as O-SIIs, as per the identification methodology outlined in section 3.0, are required to maintain an applicable capital buffer, which consists of and is supplementary to Common Equity Tier 1 capital as a percentage of the total risk exposure amount. In view of this, the revised bucketing methodology (table 2) is based on the scores achieved in the O-SII identification stage in section 3.0, and is described in detail hereunder: [8]

1. An O-SII is classified into one of any of the five buckets presented in Table 2, depending on the O-SII score obtained with the identification methodology. Bucket 1 contains the lowest capital rate (0.25%) and bucket 5 entails the highest capital buffer rate (2.0%);
2. Intermediate buffer rates of 0.5%, 1.0% and 1.5% are also applicable, thus reinforcing a proportionate and commensurate application of an O-SII surcharge, i.e. the higher the systemic risk posed by the respective O-SII, the higher the capital buffer rate applied;
3. The overall score obtained in the identification methodology (refer to section 3.0) is used to indicate the bucket in which an institution is allocated, starting from the lowest bucket (bucket 1) as per table 2:

Table 2: O-SII bucketing methodology

Buckets	Capital Buffer Rate	Score range for each bucket (bps)
5	2.00%	1700 ≤ Score
4	1.50%	1200 ≤ Score < 1700
3	1.00%	830 ≤ Score < 1200
2	0.50%	580 ≤ Score < 830
1	0.25%	425 ≤ Score < 580

5.0 Transitory provisions

The Authorities recognise the impact that certain provisions of the measure could have on a credit institution's capital planning. In view of this, the Authorities are hereby granting a transitory period for the build-up of the O-SII buffer for newly identified O-SIIs.[9]

[8] CRDV 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 3% 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.

[9] The transitory period will be specified in the applicable yearly Statement of Decision.

6.0 Application and next steps

The capital buffer rates for designated O-SIIs are applicable as from date of publication of the Statement of Decision, which shall be made available on the Authorities' websites. Going forward, the Authorities will periodically review the methodology and carry out revisions as necessary.

Annex 1: Selection of Indicators

The applicable categories and indicators are based on those put forward in the EBA Guidelines. Additional indicators have also been included so as to take into account the specificities of the domestic financial sector. An outline of the four categories and the respective indicators under each category is provided below, together with the rationale for their inclusion.

Size

An indicator of total assets is used to measure the size of the credit institution within the sector. The larger the institution, the more difficult it is for its activities to be quickly replaced by other institutions and as a result, the greater the chance that its distress or failure would cause disruption to the financial markets in which it operates. The distress or failure of a large institution is also more likely to damage confidence in the financial system as a whole. Total assets, which is the indicator used to represent size, is therefore a key indicator of systemic importance.

Importance

The second category measures the importance of each institution vis-à-vis the others, i.e. the extent to which an institution provides financial-institution infrastructure in comparison with other institutions. In addition to 'value of domestic payment transactions', 'private sector deposits from depositors in the EU', and 'private sector loans to recipients in the EU' indicators which are mandatory in the EBA Guidelines, two more additional indicators are included. These additional indicators are; (i) 'private sector deposits from Maltese residents' and (ii) 'private sector loans to Maltese residents'. The rationale for the latter two indicators is that given the structure and characteristics of the Maltese financial sector, domestic loans and deposits are deemed as key indicators for gauging domestic systemic significance. All of the five indicators showcase the importance of an institution. The more important and un-substitutable an institution is, the greater the risk of moral hazard and negative impacts on the real economy in an adverse scenario.

Complexity

Complexity of an institution can be described as the complexity of the resolution process, which could be evaluated through the importance of market activity. In order to quantify this category, three indicators are selected: (i) the value of over-the-counter (OTC) derivatives; (ii) cross-jurisdiction liabilities; and (iii) cross-jurisdiction assets.

Interconnectedness

The last category relates to the interconnectedness of an institution which is measured as the institution's impact on the financial system of a Member State, considering the materiality of the threat that failure of the institution might have a considerable negative impact on other participants of the financial sector and in turn the real economy. Three sets of indicators are used to assess the interconnectedness of an institution: (i) intra-financial system liabilities, (ii) intra-financial system assets, and (iii) debt securities outstanding.

Annex 2: Worked example

	Bank A	**Bank B**	**Bank C**	**Bank D**
	Score in basis points	Score in basis points	Score in basis points	Score in basis points
Size				
Total Assets	400	150	2500	1200
Importance				
Value of domestic payment transactions	35	40	1500	600
Private sector deposits from depositors in the EU	750	250	3500	1500
Private sector loans to recipients in the EU	1000	300	3500	2000
Private sector deposits from Maltese residents	600	350	4500	2200
Private sector loans to Maltese residents	1000	500	4000	3000
Complexity				
Value of OTC derivatives	0	0	80	900
Cross-jurisdiction liabilities	150	200	600	300
Cross-jurisdiction claims	130	80	1300	280
Interconnectedness				
Intra-financial system liabilities	120	20	800	200
Intra-financial system assets	200	160	1800	700
Debt securities outstanding	0	0	5000	0
Calculation of Weighted Category Scores				
Size	400	150	2500	1200
Importance	668	307	3494	1966
Complexity	109	109	757	426
Interconnectedness	144	81	1670	405
Overall Weighted Averages				
	404	**192**	**2418***	**1208***
Buffer Calibration				
Applicable Buffer Rate	**0%**	**0%**	**2%**	**1.5%**

$$\begin{aligned} \textit{Overall weighted average} \\ &= (\textit{size} \times 22\%) + (\textit{importance} \times 40\%) + (\textit{complexity} \times 18\%) \\ &+ (\textit{interconnectedness} \times 20\%) \end{aligned}$$

*Exceeds 425 basis points threshold

Annex 3: Overview of the 2016 O-SII identification methodology

In line with the then CRDIV/CRR framework, on 1 January 2016, the Authorities, introduced for the first time a Policy Document on the identification of O-SIIs and the calibration of the related capital buffer (hereinafter referred to as the '2016 O-SII methodology'). The measure was introduced with the aim of increasing the loss-absorbing capacity of institutions that are deemed to be of high systemic relevance.

Following a public consultation on the methodology for the identification of O-SIIs and the related capital buffer calibration in 2016, the Authorities introduced a framework which reflected more the domestic specificities of the Maltese banking sector.[10] While the domestic framework essentially deviated from the European Banking Authority (EBA) Guidelines (EBA/GL/2014/10), this was still in line with the Basel Committee on Banking Supervision (BCBS) Guidelines.[11] The motivation for deviating from the EBA Guidelines essentially reflected the fact that given the structure of the banking sector in Malta at the time, the EBA methodology was capturing as O-SIIs a number of banks licensed in Malta, which however had exhibited limited systemic relevance to the domestic economy.

The 2016 O-SII methodology was based on a two-stepped approach. As a first step, the Authorities assessed systemically important institutions on the basis of their relevance within the domestic financial sector based on the following criteria: (i) size, (ii) substitutability, (iii) cross border activity and (iv) resident interconnectedness, on the basis of a system of z-scoring. Institutions with an overall result exceeding the value of 1, i.e. beyond one standard deviation from the mean, were classified as O-SIIs based on the above-mentioned criteria.

The 2016 O-SII identification methodology also included a second step whereby authorities assessed whether further institutions should be designated as O-SIIs based on two additional indicators:

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

Irrespective of the first step, an institution that meets both criteria listed in points 1 and 2 above would still be subject to an O-SII capital buffer.

[10] CBM-MFSA Policy Document on the methodology for the identification of other systemically important institutions and the related capital buffer calibration: https://centralbank-frontend.staging.dd.com.mt/file.aspx?f=261803

[11] A framework for dealing with domestic systemically important banks, October 2012, Bank for International Settlements

Table 3: Comparison between the 2016 O-SII Methodology and the Revised Methodology

2016 O-SII Methodology				Revised O-SII Methodology			
Criterions	**Indicators**	**Weight**		**Criterions**	**Indicators**	**Weight**	
Size	Total Assets	20.00%	20%	Size	Total assets	22.00%	22%
Substitutability	Resident customer loans	13.33%	40%	Importance	Value of domestic payment transactions	8.00%	40%
	Resident customer deposits	13.33%			Private sector deposits from depositors in the EU	5.50%	
	Holdings of Government debt	13.33%			Private sector loans to recipients in the EU	5.50%	
					Private sector deposits from Maltese residents	10.50%	
					Private sector loans to Maltese residents	10.50%	
Cross-Border Activity	Cross-border assets	10.00%	20%	Complexity	Value of OTC derivatives (notional)	4.00%	18%
	Cross-border liabilities	10.00%			Cross-jurisdictional liabilities	7.00%	
					Cross-jurisdictional claims	7.00%	
Resident Interconectedness	Resident Interbank assets	10.00%	20%	Interconnectedness	Intra-financial system liabilities	9.00%	20%
	Resident Interbank liabilities	10.00%			Intra-financial system assets	9.00%	
					Debt securities outstanding	2.00%	
Scoring System		Weighted average - Z-scoring		Scoring System		Weighted Average - Basis points	
Identification criteria		Step 1 - Standard deviation from the mean ≥ 1		Identification criteria		Overall score ≥ 425 basis points	
		Step 2 - 1. Size ≥ 25% of domestic GDP; and 2. Covered Deposits ≥ 2.5 times the domestic Depositor Compensation Scheme (DCS) funding					
Calibration	4 Buckets	Exceed Step 2 thresholds	0.5% Capital buffer	Calibration	5 buckets	425 ≤ Score < 580	0.25% Capital buffer
		1 ≤ Score < 1.25	1.0% Capital buffer			580 ≤ Score < 830	0.5% Capital buffer
		1.25 ≤ Score < 1.75	1.5% Capital buffer			830 ≤ Score < 1200	1.0% Capital buffer
		1.75 ≤ Score	2.0% Capital buffer			1200 ≤ Score < 1700	1.5% Capital buffer
						1700 ≤ Score	2.0% Capital buffer